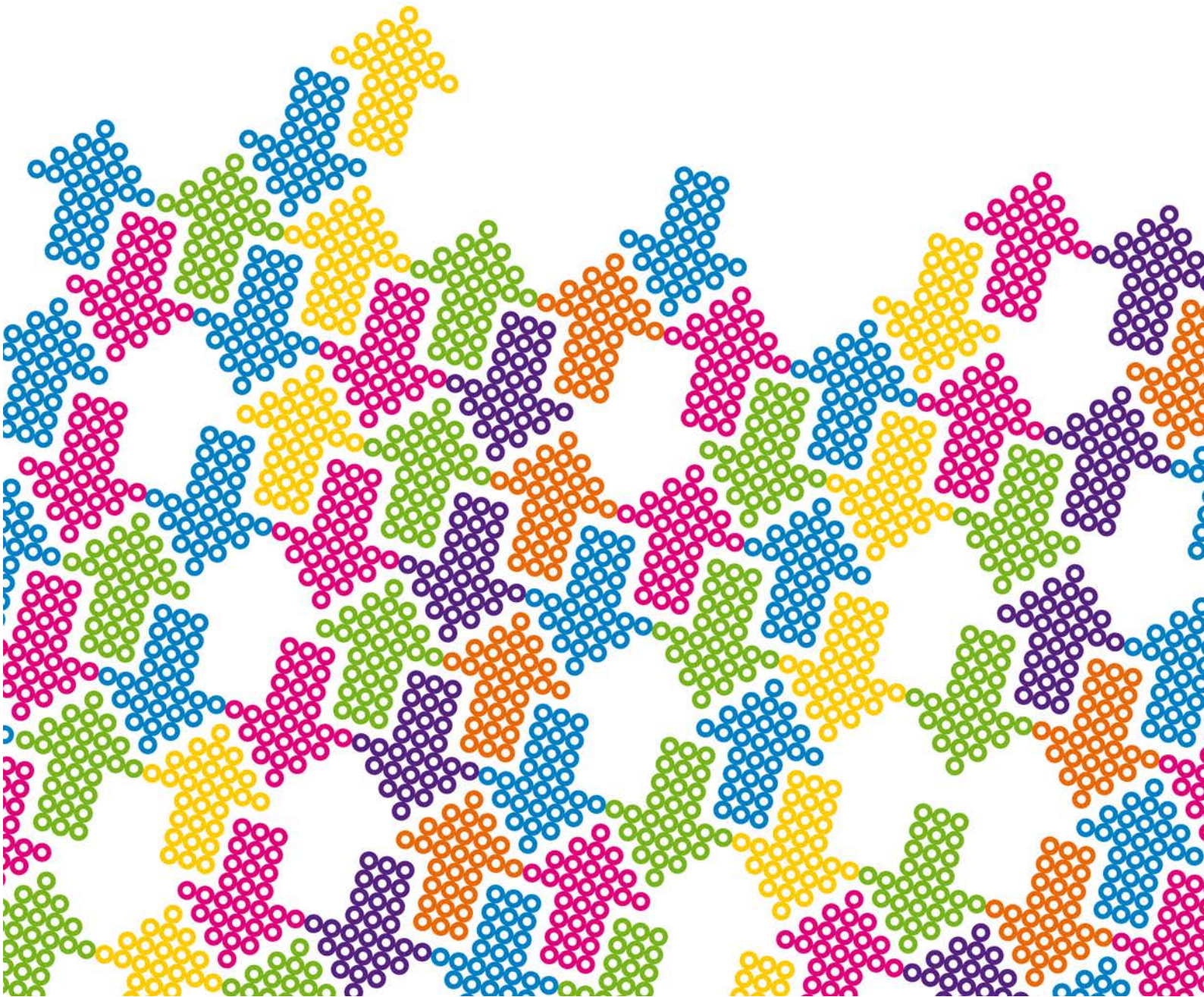




# Ireland's Competitiveness Challenge 2016

December 2016





### Introduction to the National Competitiveness Council

The National Competitiveness Council (NCC) reports to the Taoiseach and the Government, through the Minister for Jobs, Enterprise and Innovation 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:

- Ireland’s Competitiveness Scorecard provides a comprehensive statistical assessment of Ireland’s competitiveness performance; and
- 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:

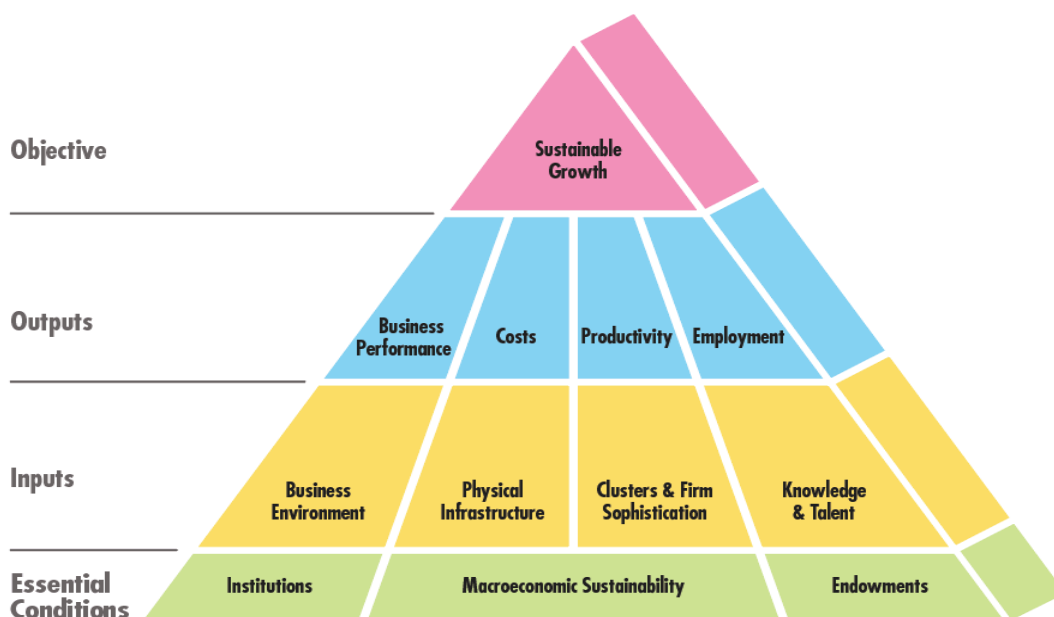
- Publishes the Costs of Doing Business where key business costs in Ireland are benchmarked against costs in competitor countries; and
- Provides an annual Submission to the Action Plan for Jobs and other papers on specific competitiveness issues.

The work of the National Competitiveness Council is underpinned by research and analysis undertaken by the Strategic Policy Division of the Department of Jobs, Enterprise and Innovation.

### The NCC’s Competitiveness Framework

The Council defines national competitiveness as the ability of enterprises to compete successfully in international markets. National competitiveness is a broad concept that encompasses the diverse range of factors which result in firms in Ireland achieving success in international markets. For the Council, the goal of national competitiveness is to provide Ireland’s people with the opportunity to improve their living standards and quality of life. The Council uses a “competitiveness pyramid” to illustrate the various factors (essential conditions, policy inputs and outputs), which combine to determine overall competitiveness and sustainable growth. Under this framework, competitiveness is not an end in itself, but a means of achieving sustainable improvements in living standards and quality of life.

#### The NCC Competitiveness Framework



### National Competitiveness Council Members

Prof Peter Clinch	Chair, National Competitiveness Council
Pat Beirne	Chief Executive Officer, Mergon Group
Kevin Callinan	Deputy General Secretary, IMPACT Trade Union
Micheál Collins	Senior Research Officer, University College Dublin
Isolde Goggin	Chair, Competition and Consumer Protection Commission
Cathriona Hallahan	CEO/Managing Director (Ireland), Microsoft
Declan Hughes	Assistant Secretary, Department of Jobs, Enterprise and Innovation
Jane Magnier	Joint Managing Director, Abbey Tours
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Dave Shanahan	Chief Executive, Adagio Ventures Commercialisation Partners
Martin Shanahan	Chief Executive, IDA Ireland
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### Taoiseach's Foreword



The Government's priority is to build a strong economy that can support a fair society. Developing a strong competitive economy is not an easy task and now we face a new set of challenges, not least from the decision of the United Kingdom to leave the European Union. Thankfully our economic position has moved to a much better position which was only possible by taking the right decisions in Government and through the understanding and sacrifices of our people. The economy is growing strongly and sustainably, with GDP expected to grow by 4.25 per cent in 2016 and 3.5 per cent in 2017. For the first time since 2009, there are over 2 million people at work, with further strong growth forecasted. Jobs are being created across the country and across sectors. Unemployment, from a high of more than 15 per cent, now stands at 7.7 per cent, and people are moving back into the country.

These are encouraging developments and offer us a strong platform from which to grow for the future.

But big international challenges will have to be overcome – the impacts of Brexit will be significant for Ireland, and for Europe. There is a trend towards greater geo-political uncertainty. Global economic growth is predicted to remain sluggish, and the potential for shocks remains.

At home too we face challenges – including in relation to infrastructure and housing. To build a strong economy – to protect jobs and to continue to expand enterprise - we need to make sure that we maintain and strengthen our competitive position.

Through the efforts of Government, our enterprises and our workers, Ireland's performance in recent years has been a strong one and has been reflected in improved international rankings. I am confident that with the same commitment, focus and cooperation we can do more.

We need to continue our efforts to control and reduce costs – whether property, insurance, legal services, finance or energy.

To position ourselves to reduce risk and to maximise opportunity, we need to help businesses export into new markets and make the most of new growth opportunities.

We need to unleash our strong culture of entrepreneurship that drives a dynamic and ambitious indigenous export sector, capable of competing and winning on the international stage.

We need to remain an attractive place for investment, and we need to ensure that we can develop and attract the skills and talent necessary to support future growth.

Having sacrificed so much to secure our economic recovery, we need to guard and protect what we have achieved. We cannot and will not put hard-won gains at risk.

This Competitiveness Challenge from the National Competitiveness Council reminds us of these important issues and maps out clearly the areas that demand our attention. It is a further valuable input for policymakers across Government, and it will support and inform us in the work that we need to do.

Enda Kenny, T.D.,  
Taoiseach

### Chairman's Preface



While the economy is in its strongest place since the onset of the recession, it faces a serious and imminent threat from external factors beyond our control, including Brexit, a potential shift in economic policy in the US and the uncertain nature of the political economy of the EU. This makes it crucial that we address those factors within our control such as maintaining cost competitiveness and investing in supporting infrastructure and talent. In uncertain times, this is the key to maintaining the economic progress we have made.

Looking back at previous Council reports, despite the very different economic landscape in which we find ourselves today, similar themes emerge time and time again. This should not be surprising. The fundamentals of competitiveness, and indeed the wider economy, are just that – fundamental to our success. Therefore, the essence of the Council's message has not changed but is being re-emphasised given emerging threats. We must rigorously pursue cost competitiveness, address barriers to investment and growth, drive productivity performance and be responsive to competitiveness challenges and opportunities that are emerging. Enhancing competitiveness is the route to economic growth and improving living standards and public services.

While similar themes persist, the specifics of our recommendations evolve over time to reflect changes in the economy, the scale of improvement required and, indeed, the advances achieved in countries with whom we compete. Given the strength of the recovery (at least as reflected in the national accounts), the temptation might be to think that all of the hard work is done. We have been here before, however, and it behoves us to learn from the past. We must put in place today the policies that will sustain us tomorrow. And this message of *sustainable* recovery is at the heart of this year's Competitiveness Challenge.

There are significant causes for concern and immediate threats to our ability to compete internationally. A number of short- and medium-term risks have already emerged in key areas that could undermine national competitiveness, growth and living standards. Brexit, in particular, presents us with far reaching and ongoing structural implications across a range of policy areas which directly impact on our national competitiveness. Our long standing and extensive economic and cultural ties with the UK mean that their decision to leave the EU has significant and direct consequences for us. The Council is particularly concerned at this time about the challenges confronting our indigenous enterprise sector arising from Brexit. Specifically, the cost competitiveness implications, caused by shifting exchange rates, and uncertainty regarding trade, pose real threats to continued growth. The challenges posed by Brexit provide additional motivation to pursue cost competitiveness across a range of business inputs, including property, legal and insurance. It brings into sharp focus infrastructure bottlenecks, including broadband deficits, and skills mismatches which have also become more acute, while issues such as increasing industrial unrest are emerging as immediate challenges.

In addition, as set out in this year's report, increasing productivity at firm level across the economy remains vital. Only a renewed commitment to improving competitiveness and productivity will put us in a position to increase growth, jobs and living standards in the post-Brexit environment.

Following years of fiscal retrenchment, and a general reduction in living standards, it is understandable that people wish to see a degree of payback from all of the sacrifices made. Embedding a sustainable recovery requires us to look beyond the short-term, and towards a more medium-term horizon. It is about determining the sort of economy and society we want, not tomorrow or next year, but in 5 or 10 years' time, and taking the action today necessary to deliver on this. This will require some difficult decisions - in some cases forgoing immediate but temporary gains so that we can provide for the future. Taking a longer-term view is often politically unpalatable; if we are to avoid the Irish cycle of boom and bust, however, a medium-term approach is essential.

In this year's report, we highlight a range of policy priorities which are required to support the enterprise sector. In many instances, short-term and immediate action is required to maintain economic progress. In particular, the Council has made regular inputs to the Action Plan for Jobs process in recent years, and the parallel development of APJ 2017 provides further opportunity to maintain a focus on competitiveness. The commitment to implementation inherent in the APJ process has been an important contributor to Ireland's recovery. The focus on clear actionable

recommendations, time bound targets and monitored, transparent implementation provides a good practice template. The final chapter of this report, therefore, highlights those actions which the Council believe should be prioritised for inclusion in APJ 2017 to commence in that year. The Council is addressing many familiar topics in this regard. We set out a range of fiscal measures to support growth, encourage investment, and reward entrepreneurship. We continue to highlight the need to maintain cost competitiveness. As a small open economy, dependent on trade, our cost competitiveness is a key determinant of our ability to sell our goods abroad.

The Challenge is primarily a medium-term document. Our commentary on the need for investment across a host of economic infrastructure areas will come as no surprise. We also focus on the need to develop further Ireland's enterprise base and to embed RD&I activity more deeply. Other important medium-term issues are considered, for instance, meeting our climate change commitments while maintaining strong economic growth and the need to deliver a coherent National Planning Framework that prioritises investment to support competitiveness whilst enabling our regions to realise their potential as key contributors to Ireland's economic recovery and growth.

Our willingness to make these hard choices and to plan for the medium term is far from certain.

We have already seen this in relation to fiscal policy as ever more people are removed from the income tax net. The planned phasing out of the USC will further narrow the tax base and leave a significant revenue shortfall that will have to be made up through increases in other forms of taxation. The plan to abolish the USC is in contrast to the broadening of the tax base which was implemented during the recession. This broadening was a direct response to the observation that, at the onset of the crisis, the narrow tax base was a contributory factor to a disastrous public finance position. Ensuring the tax base is broad, making the tax system more coherent and streamlined and incentivising work, enterprise and entrepreneurship remains a challenge in terms of safeguarding competitiveness.

In a distinct echo of the recent past, our housing market risks undermining our entire competitiveness offering. While the 'Rebuilding Ireland' Plan presents a wide-ranging set of welcome commitments, many of these will take time to implement and to effect change. We must, however, resist introducing policies which promise - but fail - to deliver a quick fix. In a situation where supply is constrained and demand is strong, rising housing prices are an inevitable consequence. This applies to both the rental and purchasing sectors and tinkering with the demand side simply favours one group over another and risks increasing prices further. Rather than chasing short-term wins, we need to show courage and pursue medium-term solutions. Our competitiveness in five and ten years will be determined by decisions made now. In this regard, as well as addressing the housing market as a matter of the utmost urgency, two additional specific and important areas spring to mind:

So much of our economic success – our strong track record in winning foreign direct investment and the growth of a cohort of internationally trading indigenous companies – is a result of our skilled workforce. Our Higher-Education Institutions have been a vital channel through which the skills needed by enterprise are developed. The demands that we place on the Higher Education system are increasing – both in terms of capacity, as ever more people complete post-primary education and seek to progress into higher education, and as a result of the increasing demands for higher skill levels by employers. At the same time, the level of resourcing per student for higher education in Ireland is significantly lower than in most of our competitor countries. Failure to tackle the under-resourcing of higher education is placing Ireland at a considerable disadvantage internationally – and we are already seeing some of the impact of this in the most recent international university rankings. Furthermore, the longer we postpone a decision about how best to address funding for higher education, the greater the negative impact on education quality, and the more challenging the issue will become to resolve. While controversial, if we are to avoid damaging Ireland's competitiveness, we have no option but to introduce a funding model for higher education that combines increased State funding alongside deferred payment of fees through income contingent loans. Such an approach will require careful design to minimise any regressive effects which may arise, and to ensure that an appropriate and effective model of student support is in place to assist those most in need.

Delivering world class water and waste-water infrastructure is a long-term project, but it is a project that must commence today. A clear plan must be developed that provides certainty with regard to the future funding of public water and wastewater services in Ireland. Resolution of the funding question is paramount to secure the necessary investment for Irish Water. The funding model must not only deliver an adequate funding stream to facilitate essential investment, it should reward conservation and it must also meet our EU objectives in terms of the user pays principle,



and the avoidance of cross subsidisation. Failure to put in place adequate water and waste water infrastructure throughout the country damages the competitiveness of all of our regions as places to live and work, and places the viability of a range of companies and sectors at risk.

In my foreword last year I noted that, in the past, the national and international authorities were watching the wrong indicators and missed significant economic threats emerging. This year, I would go further: if we refuse to learn from the lessons of the past, if we do not seize the opportunity to put in place more solid foundations for growth, we are undermining Ireland's competitiveness and putting at risk our future prosperity. Many of the actions the Council is recommending are medium-term in nature and will not bear fruit for some time. But they are necessary to secure our future jobs, wages and the quality of our public services. However, the political system tends to be short-termist. We have learnt to our cost the results of failing to consider fully the future consequences of actions and lack of actions. We must not do that again. Courageous decisions taken today can secure a sustainable, prosperous future for the Irish people.

I would like to thank the Members and Advisors of the Council for their valuable contributions in producing this report. On behalf of the Council, I would also like to acknowledge the work of the members of the Executive for their essential support and their excellent research and analysis.

Professor Peter Clinch  
Chairman, National Competitiveness Council

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## Introduction to Ireland's Competitiveness Challenge

### Background

National competitiveness is a broad concept that encompasses a diverse range of factors, essential conditions and policy inputs including education and training, innovation, clusters and firm sophistication, Ireland's economic and technological infrastructure, and the business environment (which includes entrepreneurship, taxation and the regulatory framework). Competitiveness is not an end in itself, but is a means of achieving sustainable improvements in living standards and quality of life. Only by ensuring that firms based in Ireland can compete successfully here and abroad can we create the employment, income and wealth necessary to improve the lives of all of our citizens.

### Ireland's Competitiveness Performance

Ireland's improving competitiveness performance over the period 2011-2016 has been central to the recovery in employment and economic growth. Since 2011, Ireland's relative international competitiveness as measured by a range of international indices has improved. Ireland moved from 16<sup>th</sup> to 7<sup>th</sup> in 2016 in the IMD's World Competitiveness Yearbook, and from 24<sup>th</sup> to 23<sup>rd</sup> in the WEF Global Competitiveness Report. In addition, the World Bank's most recent "Doing Business" report shows Ireland is now ranked 18<sup>th</sup> out of 190 countries.

While we are continuing to benefit from external factors such as low energy prices and a fragile recovery in our key markets, the Council finds that a range of emerging threats risk undermining Ireland's competitiveness particularly in the context of Brexit. The changed relationship between the UK and the EU will have far-reaching consequences for Ireland. Undoubtedly, the changed institutional arrangements between the UK and EU, and between Ireland and the UK will bring challenges. What must be made clear, however, is Ireland's consistent commitment to the EU. In uncertain times, this relationship represents a key strength for us. Likewise, our traditional close ties to the UK must be protected and fostered. Continued focus on improving our competitiveness position relative to other countries is required to deliver sustainable jobs and growth.

The environment for enterprise improved over the five year period to 2016. This is evident in Ireland's improved performance across a range of metrics, including tax revenue, exports, employment and investment. The time to start a new business, property registration and tax filing requirements, speed of electricity connection and the availability of credit have also improved.

In terms of investment, Gross Fixed Capital Expenditure continues to recover and grew by 11 per cent in 2015.

However, current levels of investment will be insufficient to meet emerging needs. The scope to improve infrastructure capacity and effectiveness in the medium term must be guided by identifying and prioritising those investments which contribute most to Ireland's competitiveness and addressing enterprise needs and bottlenecks.

Ireland's knowledge and talent represent important competitiveness strengths. The output from formal education of third level and STEM graduates is among the highest in the OECD. Of continuing concern, however, is the high proportion of the labour force with relatively low levels of formal education. Irish adults are rated below the EU average in terms of Digital skills and below the OECD average in terms of literacy and numeracy ability. Participation in lifelong learning has increased modestly since 2009, however, at 11.5 per cent, the proportion of people in Ireland aged 25-64 in receipt of education (both formal and non-formal) ranks below the euro area-19 average.

The performance of the FDI and indigenous sectors in 2015 was exceptionally strong in terms of export growth, jobs created and new investment. Looking at the indigenous enterprise sector, data from the Annual Business Survey of Economic Impact shows that the value of exports by Irish owned companies increased by 72 per cent to €16.1 billion in the period 2009-2014.

OECD data indicates that Irish labour productivity performance improved considerably between 2009 and 2014 with average annual growth of 2.7 per cent in GDP terms. Despite the overall positive trends in productivity performance, much of the improvement is a result of changes in the composition of employment. Ireland's large base of multinationals operating in high value added sectors (particularly in the Pharma and ICT sectors) also serves to boost Ireland's productivity level and, to a degree, disguises underperforming sectors.

While there have been positive developments in terms of cost competitiveness, a range of price pressures have emerged with regard to labour, property, insurance and business services costs. In relation to labour costs, the Council notes that although demands for wage increases are understandable after a period of economic stagnation and wage cuts, our relative competitive position will be negatively affected if wage growth outpaces that in competitor countries.

The Irish employment growth rate in 2015 was well above the euro area average and was relatively strong and balanced from a sectoral and regional perspective. Consistent with the increase in employment levels, unemployment and long term unemployment are on a steady downward trajectory. Concerns persist about labour force participation rates in Ireland – particularly female participation rates (62.5%) which are significantly lower than the OECD average (68.3%) – and about the still high rates of long term and youth unemployment.

Drawing together all of this analysis, the Council has identified a number of themes which form the basis of the remainder of this report. These themes are:

- Ensuring economic growth is balanced and sustainable
- Maintaining fiscal sustainability
- Investing in infrastructure
- Ensuring cost competitiveness
- Enhancing talent and skills
- Supporting innovation and productivity
- Broadening the enterprise and export base
- Increasing labour market participation
- Competitiveness implications of Brexit

More specifically, Chapter 1 focuses on the delivery and implementation of the National Planning Framework and emphasises the vital role that the NPF will play as a blueprint for sustainable development in the decades ahead. It links the NPF to a range of issues which come up throughout this report, including the provision of housing, investment in infrastructure and the growth of our enterprise base. Chapter 1 also examines the challenges and implications arising from Ireland's environmental and climate change commitments – outlining the potential costs associated with these commitments, but also highlighting the potential opportunities which exist in this space. This section is linked with proposals relating to environmental taxation in Chapter 2 and investment in energy infrastructure in Chapter 3.

Chapter 2 concentrates on fiscal policy and the need to maintain a sound budgetary position. Pointing out that the Exchequer is still running a deficit, this chapter highlights the necessity of broadening the tax base in a manner that supports employment and enterprise. It takes a medium term perspective and discusses the importance of transparency, clarity and simplicity in relation to our tax structure, and also emphasises the role that property taxes can play in creating a more sustainable tax base. Commentary on taxes on labour are also linked with the discussion in Chapter 8 on labour market participation.

Chapter 3 discusses capital investment and outlines the Council's investment priorities. Increased investment in broadband, public transport, the road network and energy are essential to support competitiveness. The possibility of accessing alternate sources of finance and driving efficiency in public spending are also considered.

While much of this report is focused on the medium term, Chapter 4 revisits the cost agenda. Relentlessly pursuing cost competitiveness across all business inputs is essential for a small, open, trade-dependent economy such as Ireland. It is also a crucial element in reducing the cost of living and improving living standards. The issues addressed here include the escalating cost of residential property and the need to boost housing supply; the need to continue the process of legal services reform and modernisation; and the importance of tackling rapidly increasing insurance costs. To complement subsequent discussions on productivity and broadening our enterprise base, the issue of access to finance is considered here also. In particular, the need to increase competition and broaden choice in the market is considered, and actions to empower consumers and develop the supply of alternate sources of finance are proposed in this regard. The development of credit markets are closely linked to the commentary on the development of residential and commercial property.

Chapter 5 recognises the fundamental importance of the education and training system to Ireland's productivity performance (discussed in Chapter 6) and continued prosperity. This year, the Challenge focuses on a small number of important skills issues – particularly the need to address the funding shortfalls in our higher education system. Actions to boost lifelong learning amongst the lower skilled, and the potential to reallocate the National Training Fund to support in-employment training are also discussed.

Chapter 6 analyses Ireland's productivity performance. Productivity is the only sustainable driver of growth in the medium term. Issues such as global value chains, ensuring access to international markets, and the importance of trade form the basis of this chapter, alongside a series of recommendations to enhance firm level productivity (i.e. management development, programmes to support efficiency etc.).

Building on the productivity discussion, Chapter 7 examines our enterprise base and sets out a series of actions to support indigenous companies and to deepen and broaden our FDI base. Innovation supports are also considered here. While productivity growth is the primary medium term driver for the economy, the labour market also has a key role to play. Chapter 8 looks at labour market participation and sets out a series of recommendations designed to make work pay, to facilitate upskilling and to improve the employability of individuals. The issue of affordable childcare as a tool to facilitate an increase in participation is also featured.

Finally, the implications of Brexit are elaborated upon in Chapter 9. While a great deal of uncertainty exists (and will persist for some time to come), this chapter outlines a range of issues which will require policy attention to support Irish firms trading with or dependent on UK markets, and to ensure that Ireland is best placed to take advantage of the opportunities and withstand the challenges posed by Brexit. The discussion on Brexit directly impacts upon actions required to broaden our enterprise base discussed in Chapter 7.

## Action Plan for Jobs 2017

A range of actions are proposed in all of the areas outlined above. In some cases, the actions address the need to complete or expedite ongoing work or to implement existing strategies. Others set out the case for particular strategies to be developed. The specificity of the recommendations range from detailed and precisely defined actions to more principled-based actions.

In finalising this report, the Council are cognisant of the parallel development of the Action Plan for Jobs 2017, which provides further opportunity to maintain a focus on competitiveness. Bearing this in mind, the final chapter of this report highlights those actions which the Council believe should be prioritised for inclusion in APJ 2017 (i.e. actions which can commence in 2017).

## Chapter 1: Balanced and Sustainable Growth

### Why Balanced Growth Matters for Competitiveness

Competitiveness is not an end in itself, but is a means of achieving sustainable improvements in living standards and quality of life. While Ireland's economy is now growing rapidly, in order to ensure that economic and jobs growth are sustainable, we must also pay close attention to the medium term. Only sustainable growth built on solid foundations will allow Ireland to finance quality public services such as health, education and social protection, improve incomes and living standards for all, create employment for all, enhance quality of life and protect the environment for future generations.

The Competitiveness Challenge is focused on the medium term. Therefore, many of the actions and recommendations throughout this report are designed to address issues of sustainability – fiscal sustainability, medium term capital investment to meet future economic and demographic requirements etc.

Demography must be a feature of any discussion about sustainability – the size and age profile of the population, amongst other factors, combine to impact upon the shape of our labour market, patterns of development and a range of other policy areas including healthcare, education and pensions policy. For example, while Ireland had the youngest population in the EU in 2014, society is ageing and over the last twenty years, the median age of the Irish population increased from 30 years in 1994 to 36 years in 2014. The increase in the numbers of older people (i.e. the dependency ratio) has clear implications for the future funding and sustainability of Ireland's healthcare and pension systems.

This chapter, however, focuses on two specific areas of concern from a sustainability perspective - regional and urban development and planning, and climate change. Both of these issues have direct impacts upon Ireland's competitiveness – failure to take decisive policy action today, could result in potentially significant longer terms costs and would ultimately undermine Ireland's ability to compete in global markets.

### Current Context

#### Sustainable Planning and Development

Population growth, density and settlement patterns are important considerations for infrastructure networks and service delivery costs, particularly in areas such as health, education and housing. Urban areas are increasingly becoming the driving forces of national economies, and are increasingly the preferred destinations for companies to locate their facilities. The Council has previously highlighted the importance of our cities for driving competitiveness, and this analysis remains just as relevant today<sup>1</sup>.

Over the past twenty years, the trend in Ireland has been that employment has concentrated in and around cities and larger towns, whilst the overall pattern of settlement has become more dispersed over wider hinterlands. As a result more people are travelling longer distances by car, resulting in traffic congestion and demands for the provision of local employment, infrastructure and services that are increasingly difficult to satisfy.

Indeed, the fiscal realities and competing demands for finite resources necessitate a rigorous process of prioritisation and sequencing of public expenditure to position Ireland to take advantage of growth opportunities. Continuation of current trends into the medium-long term would have significant implications for national competitiveness.

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<sup>1</sup> National Competitiveness Council, *Our Cities: Drivers of National Competitiveness*, Forfás, April 2009

The National Planning Framework (NPF) is currently under development and will supersede the 2002-2020 National Spatial Strategy (NSS)<sup>2</sup>. The NPF is intended to establish a 20-year framework for Irish strategic development, taking account of projected growth and development and likely population increases. The Framework will provide a strategic context for investment in national infrastructure by both the public and private sectors.

In addition to the NPF, a Planning Policy Statement has also been published which sets out a range of principles for planning authorities, other public bodies and those that engage with the planning process<sup>3</sup>. It also outlines a range of priorities for the enhancement of the planning system (e.g. the establishment of the Office of the Planning Regulator to improve oversight of the policy making and service delivery aspects of the planning system, roll-out of expanded online planning services).

The NPF must also be viewed against the backdrop of the significant streamlining of local and regional government structures which has already occurred – 88 planning authorities have been reduced down to 31; 10 regional bodies have been reduced to 3 regional assemblies.

The NPF, in seeking to influence more sustainable patterns of settlement and employment and related infrastructure over the medium-long term, has the potential to help Ireland meet a range of efficiency, emissions and renewables targets. Implementation of the NPF, therefore, is fundamentally linked to the climate change agenda.

### Environmental Sustainability

The sustainability of the natural environment and a commitment to environmentally friendly policies is a key determinant of long term quality of life. Climate change presents very significant challenges for Ireland, both in terms of mitigating our emissions and achieving national and international binding targets, as well as adapting to the effects of a changing climate.

On the other hand, successful carbon mitigation policies offer potentially significant rewards. Meeting our targets will create economic, enterprise and environmental benefits for Ireland: were EU 2020 targets to be achieved, not only would this reduce emissions levels – providing a boost in quality of life for all - it would also be accompanied by significant financial benefits, estimated to be worth €8 billion to the economy in net present value (NPV) terms<sup>4</sup>. A range of sectoral opportunities related to the creation of a low carbon economy also exist. For instance, the Green Economy is one of the most dynamic and rapidly growing markets in the world economy, driven by factors such as climate change, diminishing natural resources and consumer preference. For Ireland, the Green Economy presents a major opportunity for employment creation and the development of indigenous enterprise and the export of innovative products and services. The term Green Economy covers a wide range of sectors that have in common the objective of providing goods and services in a sustainable way that makes more efficient use of natural resources and reduces impact on the environment. In Ireland, the Green Economy covers activities such as sustainable food production, tourism, green financial services, green products and services, resource management and waste management, water and waste water management, renewable energy, smart grids and energy efficiency<sup>5</sup>. Likewise,

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<sup>2</sup> A roadmap for the preparation of the NPF was published in December 2015. See Department of the Environment, Community and Local Government, Towards a National Planning Framework: A Roadmap for the Delivery of the National Planning Framework, December 2015

<sup>3</sup> Department of the Environment, Community and Local Government, Planning Policy Statement 2015, January 2015

<sup>4</sup> Investing in energy efficiency, sufficient to bridge the gap to the 2020 energy efficiency target, is estimated to bring savings of over €11 billion. These benefits flow from an investment of over €3 billion which delivers a Net Present Value (NPV) – that is, net savings – of €8 billion. This is before multiple benefits such as health, business productivity and security of energy supply benefits resulting from energy efficiency improvements are included. See SEAI, Unlocking the Energy Efficiency Opportunity, 2015

<sup>5</sup> The Government Policy Statement on Growth and Jobs in the Green Economy in Ireland, Delivering our Green Potential was published in 2012. A Progress Report on Growth and Employment in the Green Economy in Ireland was published by the Department of Jobs, Enterprise and Innovation in December 2013. Other sectoral reports



the European Commission's Circular Economy Package, which includes revised legislative proposals on waste to stimulate Europe's transition towards a circular economy, offers opportunities to boost global competitiveness, foster sustainable economic growth and generate new jobs.

To date, a number of policy developments have occurred designed to facilitate progress towards achieving Ireland's energy efficiency and renewable energy targets. These include:

- Ireland adopted its **National Policy Position on Climate Change** in April 2014, setting out clearly our vision and considerations in transitioning to a competitive, low-carbon, climate-resilient and environmentally sustainable economy by 2050<sup>6</sup>.
- The **Climate Action and Low-Carbon Development Act 2015** provides a statutory underpinning to the National Policy Position<sup>7</sup>.
- The **White Paper on Energy 2015-2030** sets out a framework, strategic principles and steps to guide policy and outlines the actions that Government intends to take in the energy sector from now up to 2030, taking account of European and international climate change objectives and agreements<sup>8</sup>.
- Ireland's **National Renewable Energy Action Plan (NREAP)** which outlines our national targets for the share of energy from renewable sources to be consumed in transport, electricity and heating and cooling in 2020. The Plan demonstrates how Ireland will meet its overall national target to achieve 16 per cent of energy from renewable sources by 2020.
- Following the 2009 **National Energy Efficiency Action Plan**, the Government, in 2011 launched a number of initiatives in relation to energy efficiency including Better Energy Homes: The National Upgrade Programme. In 2013, Ireland submitted its third National Energy Efficiency Action Plan (to 2020) and a Public Sector Energy Efficiency Strategy is currently being drafted.

Despite these and other initiatives, Ireland is already expected to miss its existing 2020 carbon emission reduction targets. At the very least, accelerated effort is required, above and beyond that which has occurred to date. Any compliance shortfalls in 2020 will result in the purchase of carbon credits to bridge the gap and/or fines at EU level and lead to a more arduous trajectory in the context of post-2020 targets – both in terms of future deployment and potential future compliance costs. It is clear that meeting our current and future internationally binding renewable energy and greenhouse gas emissions targets is a significant challenge for Ireland. Of particular importance here is the allocation of “fair and achievable” targets for Ireland as part of the EU's increasingly ambitious 2030 climate targets. In simplified terms, Ireland will require an increase in capital investment to achieve lower emissions, and increased current expenditure to purchase carbon allocations from other Member States or to pay resultant EU fines<sup>9</sup>. Achieving as much of our climate change targets as possible through capital investment is desirable.

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such as “Food Harvest 2020” and ‘Food Wise 2025’ (looking at the Food and Agriculture sector) and “Harnessing our Ocean Wealth: An integrated Marine Plan for Ireland” (looking at the Marine sector) consider how the potential of these sectors can be realised whilst also achieving our environmental objectives.

<sup>6</sup> The National Position identifies the long-term objective of achieving this transition on the basis of an aggregate reduction in carbon dioxide (CO<sub>2</sub>) emissions of at least 80 per cent (compared to 1990 levels) by 2050 across the electricity generation, built environment and transport sectors; and in parallel, an approach to carbon neutrality in the agriculture and land-use sector, including forestry, which does not compromise capacity for sustainable food production.

<sup>7</sup> The Act provides for the preparation of five-yearly National Adaptation Frameworks and sectoral plans drawing together the adaptation efforts of Government and the wider public sector in Ireland to address the impacts of climate change in Ireland, and for the establishment of a National Climate Change Advisory Council to advise and make recommendations to Government on actions required to significantly decarbonise the Irish economy.

<sup>8</sup> Department of Energy, Communications and Natural Resources, Ireland's Transition to a Low Carbon Energy Future 2015-2030, December 2015

<sup>9</sup> Under the EU's Effort Sharing Decision, Member States that exceed their non-ETS annual emission allocation (AEA) are permitted to transfer up to 5 per cent of their allocation to other Member States. There is no limit on the amount of AEAs that Ireland could purchase. The price of these units has yet to be determined.

### How Ireland Performs

*Ireland's Competitiveness Scorecard 2016* included a range of quality of life measures that complement more traditional measures of GDP per capita. These metrics examine income distribution, well-being and the environment.

Overall, Ireland performs well based on many objective measures of well-being (life expectancy, education attainment, hours worked, air and water quality) and health relative to the OECD and EU averages. For example, in relation to life expectancy, the latest comparable data shows that Irish life expectancy (81.1 years) is above the EU28 average (80.6 years), and that the proportion of life expectancy at age 65 lived in good health is higher for both men and women in Ireland compared with the EU28 average<sup>10</sup>.

Despite the impact of the recession, perceptions of quality of life and measures of life satisfaction show that people resident in Ireland report above average levels of life satisfaction: in the OECD's Better Life Index, Ireland performs strongly in terms of social connections, housing, personal security, health status, subjective well-being, work-life balance, civic engagement and environmental quality. On the other hand, Ireland ranks below average in relation to jobs, and income and wealth.

In terms of income, while Ireland's GDP per capita declined over the course of the recession, we remain a high income country and incomes are still above the euro area average (although in GNP per capita terms the differential between Ireland and the euro area is much narrower). As will be discussed in subsequent chapters, the Irish social welfare system has proven quite robust and has helped to minimise increases in poverty rates during the recession. As a result, the Irish Gini coefficient was 30.8 per cent in 2014 - marginally below the euro area average indicating that income distribution in Ireland is slightly more equal than in the euro area<sup>11</sup>.

In terms of how the different regions fare in employment terms, the data runs somewhat counter to popular perception and shows that there are relatively narrow differences in employment and unemployment rates between regions in Ireland particularly when compared to the much more stark regional disparities elsewhere in Europe. For example, the differential in unemployment rates across Ireland's 8 regions (12.5%) is the lowest in the euro area (30.8%)<sup>12</sup>. This may be explained, at least in part, by the prevalence of long distance commuting for access to employment.

In terms of demographics and development patterns, Ireland had the third highest percentage increase in population (14%) between 2004 and 2014 in the EU. CSO Population projections indicate that (as is the case across the OECD) an increasing age profile will be the central change in the structure of the Irish population in the coming years. The increase in the numbers of older people has clear implications for the future funding and sustainability of Ireland's healthcare and pension systems. It also impacts upon labour force participation rates (discussed in greater detail in Chapter 8).

Population density and urban structure are key considerations for economic planning and also directly impact competitiveness - particularly in relation to infrastructure networks and service delivery costs. Ireland is more sparsely populated than the EU average. In 2014 Ireland's population density was 67 persons per km<sup>2</sup>, up from 59 persons per km<sup>2</sup> in 2004. There is significant divergence across regions with population density in Dublin estimated at 1,401 persons per km<sup>2</sup> compared to 32 persons per km<sup>2</sup> in the West. In addition to Dublin, there is only one other city with a

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<sup>10</sup> Department of Health, Health in Ireland, Key Trends 2015

<sup>11</sup> The risk-of-poverty rate (15.6%) increased by 0.6 per cent in Ireland between 2009 and 2014. This is below the euro area average and the rate of increase was also less than the Euro area increase. Over the course of the recession, Ireland's welfare system cushioned the impact and risk of poverty to a degree. Excluding social transfers, the at-risk-of poverty rate in 2014 was 37.2 per cent. After social transfers, the risk-of-poverty rate is reduced to 15.6 per cent. The proportion of households at risk of in-work poverty for working households has also fallen in recent years.

<sup>12</sup> Eurostat data measures the dispersion in unemployment rates between regions - the lower the dispersion rate, the greater the level of cohesion between regions.

population of more than 100,000, and three with more than 50,000 people, much less than comparably sized developed countries. It is of particular note that there is no centre of population with more than 20,000 people in the Republic of Ireland, north of a notional line from Galway to Dundalk.

Looking at our environmental performance, total greenhouse gas (GHG) emissions increased by 2.5 per cent between 1990 and 2014. Emissions by the energy, industry, residential and waste sectors declined and are now below 1990 levels. Transport emissions, however, have increased by 120 per cent. While Ireland overachieved in terms of our annual obligations in the early years of the compliance period, this will not be sufficient to meet our overall compliance obligations. The EPA estimates that Ireland's will achieve a reduction in emissions of between 6-11 per cent relative to 2005 compared to the target reduction of 20 per cent<sup>13</sup>.

Ireland has made progress in decoupling its emission levels from economic growth. This is a result of changes in the structure of the economy, particularly the growth of the less energy intensive services sector, greater use of gas and renewables, and improved energy efficiency. The share of renewable energy production in Ireland continues to grow (albeit from a low base) with 9.1 per cent of gross final consumption derived from renewables in 2015. Although it is declining, Ireland continues to have a very high dependence on imported fossil fuels, particularly oil: 48 per cent of Ireland's energy consumption is based on oil.

While the focus in this chapter is on meeting Ireland's international emissions targets, a range of other environmental challenges persist; the issue of water quality and capacity is considered in Chapter 3 in greater detail. While drinking water quality in Ireland is considered generally safe (99.9 per cent of public water samples comply with microbiological parameters<sup>14</sup>) a continued focus on ensuring it remains so is required as contamination of water supplies can have a major impact not only on health and wellbeing but also on enterprise, particularly in the food and biopharma sectors. This requires significant capital investment and a resolution of the current domestic charging impasse.

Challenges remain in relation to waste management. Although EPA data shows Ireland has made significant progress in meeting the majority of its EU waste recycling, recovery and diversion targets, Ireland still generates more waste per capita than the euro area average and is amongst the highest in the OECD<sup>15</sup>.

## Policy Challenges and Recommendations

### Delivering Balanced Growth: The Role of the National Planning Framework

The differences in population density, settlement pattern and urban structure between Irish regions reflect long run development patterns in Ireland. Recent trends are such that over the past twenty years, almost half of national population growth (45%), which amounts to more than 500,000 people, occurred in just six local authority areas, all of which adjoin but none of which include the cities of Dublin, Cork and Galway<sup>16</sup>. Since 1996, only 17 per cent of national population growth has taken place in the five Cities<sup>17</sup>. The balance (or 38 per cent) of population growth occurred elsewhere.

The rate of urbanisation - while increasing - is relatively low in Ireland. Approximately 57 per cent of the population live in settlements of 5,000 people or more, with the remaining 40 per cent living in smaller settlements and rural areas. The relative size of Dublin is also an important consideration from a planning and development perspective, with 25

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<sup>13</sup> Environmental Protection Agency, Greenhouse Gas Emission Projections to 2020, 2016

<sup>14</sup> Environmental Protection Agency, Drinking Water Report, 2014

<sup>15</sup> Environmental Protection Agency, Progress Towards EU Waste Targets, 2016

<sup>16</sup> Fingal, Meath, Kildare & Wicklow and Counties Galway and Cork i.e. excluding the latter two City Council areas

<sup>17</sup> Dublin, Cork, Galway, Limerick, & Waterford City Council areas and South Dublin and Dun-Laoghaire Rathdown County Councils

per cent of the total population resident in the Dublin built-up area. There are also pronounced differences between Dublin and other regions in terms of the scale and sectoral composition of employment (e.g. share of knowledge intensive services, GVA, economic output), participation rates, prevalence of commuting, infrastructure etc.

The contrast between the developmental trajectory of Dublin (and more recently a growing commuter belt associated with it) and the rest of the country, particularly regional cities, also reflects long-run development patterns and the relatively recent emergence of national and regional planning policy.

Globally, the number and scale of cities continues to grow, driven by rapid urbanisation in emerging economies and continued urbanisation in advanced economies. With more people (and consequently more skills) concentrating in cities, urban areas are increasingly becoming the driving forces of national economies, and are the preferred destinations for companies to locate their facilities. Urban areas have been found to reach systematically higher levels of performance and focus on specific, often knowledge-driven, activities. On the other hand, they are also exposed to specific congestion costs.

Dublin's housing growth has been significantly accommodated in adjoining local authority areas at relatively low residential densities based on private transport. This has worked against the large-scale provision of higher density housing choice and a reliable public transport system. Clearly, a continuation of this is neither good for Dublin nor Ireland.

To address these issues in the context of intensified global competition for investment and talent, Ireland needs to provide a choice of strong and attractive city and regional locations. The concept of balanced regional development is often interpreted as a redistribution of economic activity and population to achieve economic 'equalisation' across the country. This is not what was intended by the National Spatial Strategy or now by the NPF, but rather that regions are enabled to realise their potential as key contributors to Ireland's economic recovery and growth.

While supportive of policies to develop all regions, the Council believes that Ireland cannot afford to ignore irresistible global trends. The key policy choice for Ireland is whether those irresistible global trends towards an increased share of population living in urban areas will lead to a further growth of Dublin (particularly its commuter catchment area) and, to a lesser extent, some regional cities, or a more balanced approach encompassing the development of Dublin and emergence of real points of regional strength to complement Dublin.

We must, therefore, strike a balance between facilitating the growth of Dublin and bringing forward the accelerated development of a "next tier" of cities as key engines of economic performance, whilst simultaneously unlocking the potential of their wider regions and their urban and rural drivers of economic activity.

As mentioned, the NPF is currently being developed by the Department of Housing, Planning, Community and Local Government. It is being developed in tandem with the preparation of new Regional Spatial and Economic Strategies (RSEs) by the three new Regional Assemblies, established to co-ordinate relevant local authorities under the Local Government Act 2014. The NPF and RSEs will together provide national and regional planning and economic development strategies for the country as a whole.

The National Planning Framework (NPF), which is scheduled for publication in draft form in Q1 2017, is a key policy instrument that is urgently required to support coherent investment prioritisation at national and regional level. The NPF should provide the basis for an urban policy for Ireland with progressive urban design, place-making and investment priorities to facilitate both business and lifestyle opportunities.

Targeted investment should anticipate future demands to the greatest extent possible. Well planned and executed public capital investment influences patterns of development and economic growth by boosting long run potential output. It also improves productivity and competitiveness, through efficiency gains and reduced costs. Coherence between capital investment budgets and national strategic planning is critical – therefore, developing coherent and clear linkages between the objectives set out in the NPF and the objectives of the Mid-Term Review of the Capital Plan is essential.

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**Recommendation:** Publish the National Planning Framework and ensure that the principles of the NPF are subsequently reflected in the planned Mid-Term Review of the Capital Plan.

**Responsibility:** Department of Housing, Planning, Community and Local Government, Department of Public Expenditure and Reform

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There is a strong interdependency between planning, development and creation of an attractive environment, enterprise growth and talent attraction. The development of acceptable models of higher density housing choice is also dependent on ensuring the 'liveability' of urban areas, which extends to amenities and services. Such place-making factors are also important for a vibrant and competitive tourism sector. Residential, commercial and infrastructural development must be coordinated and complementary. Coherence and coordination between all bodies with responsibilities in this broad area is essential to ensure efficient and timely delivery of infrastructure at regional level.

Ireland at present has a somewhat fragmented institutional framework when it comes to urban policy and infrastructure planning. The NPF can build on the Regional Action Plan for Jobs to provide an effective forward planning framework for Ireland over the longer term and needs to explicitly set out an urban and regional investment policy for Ireland with progressive urban design and place-making investment priorities to facilitate both business and lifestyle opportunities. Rolling capital investment strategies will be required to implement the NPF and this aspect of the Framework will be a crucial implementation mechanism.

More detailed discussion on the need for infrastructural reform is contained in Chapter 3.

The new NPF should provide the context for mandatory rigorous ex ante cost/benefit analysis of the delivery of additional publically-funded infrastructure, mindful of the wider public good, and agreed regional development objectives.

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**Recommendation:** Ensure that the National Planning Framework provides the context for mandatory rigorous ex ante cost/benefit analysis of the delivery of additional publically-funded infrastructure.

**Responsibility:** Department of Housing, Planning, Community and Local Government, Department of Public Expenditure and Reform, Irish Government Economic and Evaluation Service

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### Delivering a Low Carbon Economy and Minimising the Impact on Competitiveness

Climate change represents an urgent and potentially irreversible threat to society and requires the widest possible cooperation by all countries with a view to accelerating the reduction of global greenhouse gas emissions. The Paris Agreement under the United Nations Framework Convention on Climate Change (UNFCCC) represents a global effort to limit global temperature increases to less than 2 degrees and to pursue efforts to limit the temperature increase to 1.5 degrees above pre-industrial levels and aims to share the benefits and burdens of the agreement fairly across developed and developing economies.

Within Europe, the existing EU 2020 Climate and Energy Package (referred to as "20-20-20") targets a reduction in greenhouse gas emissions (GHG) of 20 per cent from 1990 levels, an increase in the share of renewable energy to 20 per cent of consumption, and improvements in energy efficiency of 20 per cent.

The main EU instrument to reduce greenhouse gas emissions is the EU **Emissions Trading Scheme (ETS)**. ETS which currently covers about 45 per cent of EU emissions, and just over a quarter of total emissions in Ireland, has an objective to reduce emissions in heavy industry covered by the Scheme by 21 per cent relative to 2005 levels.

Sectors not covered in the ETS (the "non-ETS sector") include agriculture, transport, the built environment (i.e. domestic and non-ETS industry) and waste.

Under the 2009 EU Effort Sharing Decision (ESD), which applies to the non-ETS sector, Ireland has a series of particularly challenging commitments. Between 2013 and 2020, Ireland has a target to reduce GHG emissions to 20 per cent below 2005 levels. This target is partially calculated on the basis of GDP per capita and is the most demanding 2020 reduction target allocated under the ESD - one shared only by Denmark and Luxembourg<sup>18</sup>. This is of particular relevance to Ireland because of the very high proportion of these emissions arising from agriculture. Ireland has also committed to increasing the share of renewables in final energy consumption to 16 per cent by 2020 and to move towards a 20 per cent increase in energy efficiency.

Based on existing policy measures, Ireland will miss its national emission reduction targets<sup>19</sup>, and its targets in relation to renewables. According to the Environmental Protection Agency (EPA), non-ETS emissions will, at best, be 11 per cent below 2005 levels, and Ireland could breach its emissions target by between 6 and 11 per cent<sup>20</sup>. Failure to comply may incur significant costs: the EPA has estimated that between €50m and €300m in additional expenditure may be required for the purchase of carbon credits to make up for the shortfall to 2020. Such expenditure, would obviously adversely impact the State's ability to increase capital expenditure or expenditure on social services. Furthermore, by falling short of the pre-2020 targets, this makes the post-2020 targets even more challenging.

*Ireland is not on track towards decarbonising the economy in the long term and will face steep challenges post-2020 unless further policies and measures are put in place over and above those envisaged between now and 2020.*

*Environmental Protection Agency, 2015*

Looking forward, the EU's 2030 climate and energy framework sets even more ambitious key targets for emissions reduction, renewables and energy efficiency:

- To reduce GHG emissions by at least 40 per cent compared to 1990 – to achieve the overall 40 per cent target, the sectors covered by the EU ETS would have to reduce their emissions by 43 per cent compared with 2005 levels, while sectors outside of the ETS would need a reduction of 30 per cent compared with 2005;
- To increase the share of renewable energy to at least 27 per cent of total energy used; and
- To improve energy efficiency by at least 27 per cent.

As a result, the Commission, in its recently published Effort Sharing Proposals has indicated that Ireland will have to reduce its carbon emissions by up to 30 per cent compared to 2005 levels between now and 2030<sup>21</sup>. These binding new

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<sup>18</sup> Department of the Environment, Community and Local Government, Invitation to Submit Views on the Development of Ireland's First National Low Carbon Transition and Mitigation Plan, 2015

<sup>19</sup> The European Commission estimates that Ireland could miss its target by 10 per cent. See European Commission, Country Report for Ireland, 2016

<sup>20</sup> Greenhouse gas emissions are projected to 2020 using two scenarios; With Measures and With Additional Measures. The With Measures scenario assumes that no additional policies and measures, beyond those already in place by the end of 2014 (latest national greenhouse gas emission inventory), are implemented. The With Additional Measures scenario assumes implementation of the With Measures scenario in addition to full achievement of Government renewable and energy efficiency targets for 2020, as set out in the National Renewable Energy Action Plan and the National Energy Efficiency Action Plan. Ireland's non-ETS emissions are projected to be 6 per cent and 11 per cent below 2005 levels in 2020 under the With Measures and With Additional Measures scenarios, respectively. The latest projections estimate that by 2020 non-ETS emissions will at best be 11 per cent below 2005 levels compared to the 20 per cent reduction target. The broad range of these estimates reflect the uncertainty around compliance costs in the as yet non-existent compliance market for renewable energy target compliance as well as the uncertainty around macroeconomic projections and attendant energy and emissions forecasts to 2020. See EPA, Ireland's Greenhouse Gas Emission Projections 2014-2035, May 2015

<sup>21</sup> The national targets established in the proposal are not just for the year 2030. The proposal sets a limit for each year in the 10 year period up to 2030. The limit for each year is set according to a decreasing linear trajectory. This ensures year on year reductions.

targets were announced by the EU Commission in July 2016, and as before are based on Ireland's relative share of GDP per capita in the EU<sup>22</sup>. Further detail on how the non-ETS burden will be shared amongst Member States between 2021 and 2030 remains the subject of ongoing negotiations.

It should be noted that one-off flexibility allowed under the Emissions Trading System, and flexibility for land use, land use change and the forestry sector could reduce the headline 30% target by up to 9.6 per cent, although not without accruing significant exchequer costs<sup>23</sup>: eligible Member States can achieve a proportion of their national targets by covering some emissions in the non-Emission Trading System sectors with EU Emission Trading System allowances which would normally have been auctioned, generating revenue for that Member State. As a result, use of these flexibilities could entail Exchequer costs running to several hundred million euros. The starting point for the linear target trajectory is set from 2020 as the average emissions in 2016-2018 because this will be the latest data available in 2020.

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**Recommendation:** Ensure that the baseline for Ireland's 2030 emissions targets accurately reflects Ireland's relative share of GDP per capita vis-à-vis other EU member states. This is of particular relevance given recent distortions in National Accounts data.

**Responsibility:** Department of Communications, Climate Action and Environment

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Agriculture is Ireland's largest contributor to carbon emissions by economic sector, responsible for 47 per cent of total non-ETS emissions. The next largest emitting sector is transport, at 29 per cent of non-ETS emissions. Emissions from both sectors are projected to increase in the period to 2020. It is clear that Ireland faces significant challenges in meeting emission reduction targets for 2020 and beyond.

The potential Exchequer exposure to EU fines should we fail to meet our emissions targets should inform our thinking about capital budgets. Sectors such as transport and agriculture have relatively limited scope for emissions reductions unless a major capital investment programme is implemented in the case of transport, or agri-food output is curbed in the case of agriculture<sup>24</sup>. It is generally believed that there are limited cost-effective opportunities for reductions in agricultural emissions without negatively impacting production. In the case of transport, the dispersed nature of the Irish population makes the provision of improved regional public transport options problematic from a cost-effectiveness criterion. It will be difficult to realise reduced emissions from this sector without major modal shift towards public transport, dramatic improvements in vehicle emissions standards (i.e. an accelerated move to close-to-zero emissions), dramatically increased penetration of electric vehicles, and significant shifts away from current commuting patterns.

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<sup>22</sup> Issues relating to the National Accounts and the degree to which current measures reflect real economic activity are discussed in more detail in Chapter 2.

<sup>23</sup> Teagasc have estimated that forestry costs the exchequer between €26 and €42 per tonne of carbon sequestered. See Teagasc, A Marginal Abatement Cost Curve for Irish Agriculture: Teagasc submission to the National Climate Policy Development Consultation, April 2012

<sup>24</sup> For the first time, the National Infrastructure and Capital Investment Plan 2016-2021 includes spending to tackle both climate mitigation and adaptation, with over €440m earmarked for energy efficiency and renewable energy programmes over the 6-year period. To protect vulnerable communities, the Government has also prioritised the introduction of a new flood risk management programme: by 2021, spending on this programme will be €100m per annum. Food Wise 2025 also have a chapter focussed on the sustainability of the Irish agri-food industry and there are a number of actions aimed at improving the environmental impact of the sector.

**Recommendation:** Take account of the environmental impact of individual projects – specifically on greenhouse gas emissions when prioritising investment as part of the Mid-Term Review of the Capital Plan. Particular recognition should be accorded to investments which simultaneously support competitiveness and contribute to Ireland meeting its greenhouse gas reduction targets.

**Responsibility:** Department of Public Expenditure and Reform

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**Recommendation:** Assess the potential Exchequer exposure should Ireland fail to meet its 2020 and 2030 targets for emissions reductions, renewable energy and energy efficiency as part of the National Mitigation Strategy.

**Responsibility:** Department of Public Expenditure and Reform, Department of Communications, Climate Action and Environment

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At present, the ETS system may be disadvantaging Irish companies. An anomaly exists whereby a provision allows the indirect costs associated with the scheme (i.e. ETS participants who purchase electricity in which the carbon price is already internalised) to be reimbursed to participants. Currently Ireland does not allow for any indirect cost reimbursement, while several other Member States (including France, Germany and the UK) allow for this. This creates an uneven playing field for ETS participants located in different Member States and allows for competitor plants (within the same sector) in different EU countries to have unfair advantages over each other. Any move to rectify this anomaly, however, would have implications for the Irish exchequer, the costs of which has been quantified as modest given the small number of installations that would be eligible for indirect cost recoupment.

**Recommendation:** Consider the implications of allowing the indirect costs associated with the emissions trading system (ETS) to be reimbursed to participants. Clearly outline the opportunity cost of permitting reimbursement and highlight any implications for other aspects of carbon mitigation policy.

**Responsibility:** Department of Public Expenditure and Reform, Department of Communications, Climate Action and Environment

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The Department of Communications, Climate Action and Environment chairs an inter-departmental committee that is currently assessing a range of planned and current climate change mitigation measures across all the relevant government departments with a view to prioritising the most cost-efficient measures from now up to 2020. A key principle must be to ensure that climate-change and emissions-reduction policies and measures aimed at industry do not damage economic growth or firm-level competitiveness.

Work is currently underway on developing a low carbon plan - the National Mitigation Strategy - the primary objective of which will be to track implementation of measures already underway and to identify additional measures in the longer term to reduce greenhouse gas emissions and progress the overall national low carbon transition agenda to 2050. The first iteration of the National Mitigation Strategy will place particular focus on putting the necessary measures in place to address the challenge to 2020 but also in terms of planning ahead to ensure that appropriate policies and measures will be in place beyond that. The Strategy must also outline an optimal mix of initiatives to meet our targets in a manner that minimises costs and maximises opportunities for Irish enterprise. The Strategy should also



reflect the range of actions proposed in the Energy White Paper<sup>25</sup> and the ongoing work of Sustainable Energy Authority of Ireland in this regard.

For example, SEAI note that while the policy foundation to achieve the improved energy efficiency (and related carbon reduction) is strong, it needs to be further strengthened and enhanced if Ireland is to realise the potential savings suggested. SEAI's key recommendations in this regard cover a range of interventions aimed at overcoming market failures and removing other barriers to unlock the potential of cost-effective energy efficiency measures. A range of possible actions highlighted by SEAI include the implementation of market orientated mechanisms, extending regulation (e.g. introducing minimum thermal efficiency standards in the property sector), and providing targeted information at the same time as adopting new technology<sup>26</sup>. The State already has a range of programmes and schemes in place to encourage energy efficiency and carbon mitigation. It is important that these programmes are continuously reviewed to ensure that they succeed in incentivising the desired behaviours.

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**Recommendation:** Expedite the publication of the first National Mitigation Strategy, and proceed rapidly to implement the agreed actions. Actions should be time bound with the clearly identified responsibilities and actors. The Plan should also include precise sub-sector targets.

**Responsibility:** Department of Communications, Climate Action and Environment, Department of Public Expenditure and Reform

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### Energy Efficiency

Ireland has a legally binding target for renewable energy deployment as well as a national target for energy efficiency. The pathways to achieving these targets have been set out in the National Renewable Energy Action Plan (NREAP)<sup>27</sup> and National Energy Efficiency Action Plan<sup>28</sup>. The overall renewable energy share (RES) target of 16 per cent of final energy use to be derived from renewable sources by 2020 (and a related target of 10 per cent for the transport sector) is binding at EU level. The targeted 20 per cent improvement in energy efficiency across the whole economy by 2020 is a nationally set target adopted in response to the EU Energy Efficiency Directive.

Achieving Ireland's energy targets will help us to meet our binding EU GHG emissions targets. The more energy demand is reduced through efficiency measures, the lower the effort required to achieve the renewable energy targets, and in parallel a reduction in emissions can also be achieved. For example, the electrification of the heat and transport sectors could also assist Ireland in complying with its non-ETS emissions reduction target by shifting emissions into the Emissions Trading Scheme (ETS) sector and away from the non-ETS sector. From the perspective of the firm, one of the most effective ways for firms to reduce their energy costs is to invest in energy efficiency technologies, and thus reduce energy consumption.

SEAI has previously noted that achieving these targets will require an "acceleration of deployment of renewable energy and energy efficiency technologies over the period to 2020"<sup>29</sup>. In 2013, the Government set up the National Energy Efficiency Fund with €35 million of seed capital for investment in energy efficiency projects. The Government commitment was matched by private sector investment. The Fund aims to invest in projects that reduce energy

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<sup>25</sup> Department of Communications, Energy and Natural Resources, Ireland's Transition to a Low Carbon Energy Future, 2015

<sup>26</sup> SEAI, Unlocking the Energy Efficiency Opportunity, 2015

<sup>27</sup> Department of Communications, Energy and Natural Resources, National Renewable Energy Action Plan, Submitted to the European Commission under Article 4 of Directive 2009/28/EC, 2010

<sup>28</sup> Department of Communications, Energy and Natural Resources, Maximising Ireland's Energy Efficiency: The National Energy Efficiency Action Plan 2009-2020, 2014

<sup>29</sup> SEAI, Ireland's Energy Targets: Progress, Ambition and Impacts, 2016

consumption, recover useful energy from waste streams and distributed renewable energy generation. Following the initial funding allocation, a second round of capital funding was secured at the end of 2014, with a third round due to follow in 2016.

In light of the interactions between the various environmental targets discussed above, the costs and benefits of all investment in sustainable energy must be analysed and evaluated to ensure that the most efficient and effective investments are prioritised.

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**Recommendation:** Evaluate the effectiveness of investments made to date through the National Energy Efficiency Fund, and on the basis that energy efficiency is the cheapest way to achieve GHG targets and because Ireland is not on track to achieve the 20 per cent energy efficiency target, determine whether another round of capital funding should be raised in 2016.

**Responsibility:** Department of Communications, Communications, Climate Action and Environment

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Through successive National Energy Efficiency Action Plans, Ireland has maintained its commitment to achieving a 20 per cent energy savings target in 2020 and to achieving a 33 per cent reduction in public sector energy use (as compared to average energy use over the period 2001 – 2005). These remain the central pillars of our national energy efficiency policy. Continued focus on implementation is required to deliver upon these commitments (and the commitments in the associated Public Sector Energy Efficiency Action Plan which is currently being finalised)<sup>30</sup>.

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**Recommendation:** Ensure that the energy saving commitments and targets set out in the National Energy Efficiency Action Plan (and the related Public Sector Energy Action Plan) are adhered to.

**Responsibility:** Department of Communications, Energy and Natural Resources, other Government Departments

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<sup>30</sup> The Public Sector Energy Efficiency Action Plan is intended to expedite the achievement of the 33 per cent energy efficiency target for the public sector ahead of the 2020 target.

## Chapter 2: Fiscal Sustainability

### Why Fiscal Policy Matters

Ensuring that the State's finances are prudently managed is a crucial element in providing a stable business environment in which enterprise can thrive. Essentially, fiscal governance has three main objectives:

- Attaining sound budgetary positions (i.e. conducting sustainable fiscal policy by avoiding high deficits and/or increasing debt ratios);
- Reducing the cyclical nature of fiscal policy making; and
- Improving the efficiency of public spending.

Sound public finances contribute to competitiveness and encourage economic growth mainly through their impact on borrowing costs. By avoiding excessive deficits and excessive debt levels, governments can invest in productivity and welfare enhancing areas of the economy (such as education, or infrastructure), rather than spending finite resources on interest payments.

Tax policy is a key tool for policymakers responding to changes in the economic cycle. It is also a major determinant of the competitiveness of the environment for enterprise. Policies which best facilitate and support competitiveness and growth while minimising the impact of cyclical factors are essential to maintain fiscal stability. However, the Council recognises the budgetary challenges of reducing the deficit level while at the same time ensuring that fiscal policy supports sustainable economic and employment growth, and facilitates sufficient public investment in productivity enhancing capital projects (Chapter 3).

Ireland must continue to maintain a sound budgetary position. This requires an appropriate balancing of the need to meet our obligations under the Stability and Growth Pact and put in place a sustainable, counter-cyclical, medium-term fiscal planning process with the need to increase capital investment to enhance competitiveness and support enterprise. Ultimately, the revenue generated through the taxation system funds our public services. Any loosening of fiscal discipline (i.e. unsustainable current expenditure increases, or shrinking tax ratios for example) at this stage would undo much of the progress achieved to date, and would have potentially significant negative implications for future competitiveness.

### Current Context

The EU's Stability and Growth Pact was reformed after the financial crisis through initiatives such as the Six Pack (a fiscal law package of 5 regulations and 1 directive), the Two Pack, and the Treaty on Stability, Coordination and Governance. The new rules are grounded in the European Semester, the EU's policy-making calendar. This integrated system ensures that there are clearer rules, better coordination of national policies throughout the year, regular follow-up and swifter sanctions for breaching the rules. This helps Member States to deliver on their budgetary and reform commitments while making the Economic and Monetary Union as a whole more robust. The "Six Pack" also established a medium term approach to fiscal policy and the Budget, requiring Member States to adopt a "fiscal planning horizon of at least three years". At a national level, the Fiscal Responsibility Act established the Irish Fiscal Advisory Council as a statutory body and legislated for the implementation of national and EU fiscal rules.

Ireland completed the EU-IMF financial assistance programme in 2013. As a result of the general government deficit falling below 3 per cent in 2015 the European Commission in May 2016 recommended that Ireland leave the so-called *Excessive Deficit Procedure (EDP)* thus ending the seven-year period of economic scrutiny by the Commission first imposed at the height of the economic and financial crisis. Ireland is now subject to the *preventive arm* of the Stability

and Growth Pact. This gives primacy to the structural balance (i.e. the budgetary position excluding one-off factors and taking account of the economic cycle), and imposes two key rules:

- Member States are expected to reach their **Medium Term Objective** (MTO) or to be heading towards their MTO by adjusting their structural budgetary positions by at least half a per cent of GDP annually. For Ireland, the MTO is a balanced budget in structural terms; and
- The **Expenditure Benchmark** requires that government expenditure grows at or below a country's medium-term potential economic growth rate, depending on the country's position with respect to the MTO. Any spending increases beyond this rate must be matched by additional discretionary revenue measures.

Furthermore, the Government will on an ongoing basis assess whether the budgetary stance is appropriate from a macroeconomic stability perspective. It may reassess the fiscal stance in order to ensure budgetary policy does not contribute to any overheating should the economy grow at a faster pace than expected. While the application of defined and prudent fiscal rules is welcome, there is a concern that any underestimation of Ireland's medium term growth potential, for example, could limit our ability to increase capital investment and could, therefore undermine competitiveness.

Overall, the NCC welcomes Ireland's exit from the Corrective Arm of the *Stability and Growth Pact (SGP)* within the timeline set by the European Council in December 2010, and views the adherence to the requirements of the Preventive Arm of the pact and the domestic Budgetary Rule as fundamentally important.

In relation to exchequer revenue, €33.4 billion was collected in the first nine months of 2016. This represents a year-on-year increase of €1,788 million (5.7%) and is €484 million (1.5%) above profile, with strong increases recorded across most tax categories<sup>31</sup>.

However, developments in the National Accounts highlight the potential volatility or unsustainable nature of some rapidly growing sources of recent Exchequer revenues, such as corporation tax receipts, which grew by almost 50 per cent in year-on-year terms in 2015. Past experience highlights the danger of relying on volatile and potentially transitory revenue sources, to fund increased levels of public spending, or reductions in tax rates which can prove hard to reverse. Despite this Ireland's tax revenue to GDP ratio is low compared with the EU average and has decreased marginally between 2007 and 2015.

### How Ireland Performs

Ireland has experienced a remarkable economic recovery over the past two years and both GDP and GDP per capita have already moved above their pre-crisis levels and, crucially, economic activity is more balanced between domestic sources, comprising of consumption and investment, and external sources of growth. The debt-GDP ratio is on a sharp downward trajectory - from a peak of over 120 per cent in 2012 to 93.8 per cent at the end of 2015.

Revisions to the 2015 National Income and Expenditure accounts in July 2016 led to an upgrade of the 2015 GDP growth to 26.3 per cent and GNP to 18.7 per cent. These revisions, which are in line with ESA2010<sup>32</sup> and BPM6<sup>33</sup>

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<sup>31</sup> Department of Finance, Exchequer Returns end-September 2016: Information Note, October 2016

<sup>32</sup> The European System of National and Regional Accounts (ESA 2010) is the newest internationally compatible EU accounting framework for a systematic and detailed description of an economy.

<sup>33</sup> The sixth edition of the Balance of Payments and International Investment Position Manual (BPM6, the Manual) serves as the standard framework for statistics on the transactions and positions between an economy and the rest of the world.

methodology, are largely related to relocation of multinational companies to Ireland and the resulting larger net exports contributions<sup>34</sup>. They also reflect increased investment in aircraft owned by Irish based leasing companies, which has a limited real impact on the underlying Irish economy.

Various commentators have stated these revised figures are not reflective of actual economic activity taking place in Ireland. Instead, these developments reflect the statistical 'on-shoring' of economic activity associated with an increase in the size of the Irish capital stock arising from corporate restructuring and balancing sheet reclassification in the multinational sector, and also growth in aircraft leasing activity. As a result, National Accounts data now include a very significant amount of activity carried out elsewhere, but formally recorded as part of Irish GDP and GNP.

Consequently, metrics derived from these measures, such as the various fiscal ratios-to-GDP, measures of potential output, the output gap, the structural deficit and the expenditure benchmark, have become less meaningful. The Council is concerned that the health of our public finances is being compromised by the lack of credible growth indicators as key fiscal ratios, when expressed as a share of GDP, overstate the underlying health of the government accounts. It welcomes the CSO's decision to convene a high-level cross-sector consultative group of experts, chaired by the Governor of the Central Bank, to provide guidance on how a more relevant indicator could be produced and published alongside existing measures.

Although the revisions might be one-off adjustments, there is obviously a need to develop a more meaningful, commonly agreed measure of the actual level of Irish economic activity that accurately reflects developments within the economy. Constructing such a measure is made all the more important given the potential for greater volatility in conventionally measured GDP in the future, taking account of the growing influence of corporate restructurings and balance sheet reclassifications on this aggregate.

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**Recommendation:** Develop a suite of national account measures that reflect actual real economic activity. This applies to both output and expenditure measures. Thereafter, work with Eurostat to improve their understanding of the issues which impact the Irish national accounts and ensure that EU calculations of economic activity reflect developments in the national accounts.

Continue the analysis to better understand the factors driving the national accounts results and to determine whether the changes in company accounting practices which are reflected in the national account results are a result of particular policy measures applied in Ireland or elsewhere.

**Responsibility:** Central Statistics Office

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In light of the revised National Income and Expenditure 2015 Accounts, the level of Irish economic activity appears greater than it actually is, and so the State faces a €280-380m rise in our EU contribution. The final contribution will ultimately depend on a number of variables including the size of the overall EU budget for 2017, GNI movements in other EU member states, and other EU budget operational developments<sup>35</sup>. With Ireland becoming a net contributor

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<sup>34</sup> These figures have been boosted by contract manufacturing abroad on behalf of multinational firms, including recently re-domiciled firms located here. Investment has also been revised upwards significantly to account for intellectual property assets now booked here and increased investment in aircraft located abroad but owned by Irish based leasing firms. Corporate restructuring through the relocation to Ireland of companies' entire balance sheets, the shifting of assets to Irish subsidiaries, and the takeover of foreign companies by Irish entities, have led to a dramatic increase in the level of capital assets in Ireland. The mirror image of this has been a substantial negative revision of Ireland's Net International Investment Position (NIIP) due to higher liabilities to non-residents. The relocation of companies has also been associated with an increase in "contract manufacturing", which boosts Ireland's exports and GDP.

<sup>35</sup> GNI-based resources comprising a percentage (around 0.7 per cent) of each member state's GNI represent the largest source of revenue for the EU.

to the EU Budget for the first time in 2014, new metrics are required to calculate our contribution to the overall budget given our status as a small-open economy.

### Policy Challenges and Recommendations

#### Expenditure

The NCC welcomes the commitment in the *Programme for a Partnership Government* (PfPG) to comply with all fiscal rules and to reform the budget process to allow for greater scrutiny. The document contains a list of new spending priorities while announcing an intention to reduce some taxes, add €4 billion to the existing capital investment programme and establish a Rainy Day Fund (see below). Various commentators have criticised the Programme for failing to reconcile the overall cost of the various policy proposals and provide an estimate of the resources that will be available in future years to fund new tax and spending measures. The additional capital investment in productivity enhancing areas of the economy is also welcomed. There is a need, however, to provide detailed costing plans and to evaluate expenditure proposals accordingly.

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**Recommendation:** Provide greater detail on the cost of all project spending proposals as part of the Mid-Term Review of the Capital Plan to ensure that public monies are spent in an efficient and effective manner.

**Responsibility:** Department of Public Expenditure and Reform, Irish Government Economic and Evaluation Service

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The Council notes and welcomes the commitment in the 2016 *Summer Economic Statement* to increase the number of assessments to determine whether programmes are achieving the outcomes desired. The value for money reviews should then assess if the money spent effectively and efficiently delivered successful outcomes of the programmes.

#### Performance Budgeting

In late 2015 the credit ratings agency Moody's emphasised that budget discipline is now a key risk to Irish recovery. In this regard, the Council welcomes the recent Government reforms of the budgetary architecture to enhance the quality of public finances. By launching the National Economic Dialogue (NED), the Government has indicated its willingness to strengthen transparent stakeholder participation, an objective which is very much in keeping with the international principles of "open government" advocated by the OECD and to which the Irish government has subscribed. However, some stakeholders consider that the format and nature of the NED risks marginalising the role of the Houses of the Oireachtas as the natural democratic forum for debate on such national policy issues.

*Performance Budgeting* has become a key initiative around the world in the past number of years and its ultimate aim is to strengthen the link between the resources allocated to Departments and the outcomes provided for citizens. The Fiscal Responsibility Act 2012 established the Irish Fiscal Advisory Council (IFAC) as a statutory body and legislated for the implementation of national and EU fiscal rules. The role of the Council is to independently assess, and comment publicly on whether the Government is meeting its own stated budgetary targets and objectives. It is required to assess and endorse, as it considers appropriate, the official macroeconomic forecasts underpinning each Budget and stability programme. The Council also assesses the fiscal forecasts and the fiscal stance, and monitors compliance with legislated fiscal rules.

Budget oversight by the Irish parliamentary chambers, the Houses of the Oireachtas, is under-developed by international standards<sup>36</sup> and the NCC welcomes the PFGP commitment to establish an Independent Parliamentary Budget Office (IPBO) to equip parliamentarians to engage more effectively on budgetary matters (i.e. through analysis of information on taxation, expenditure and performance, as well as policy costings). Parliamentary Budget Offices (PBOs) exist around the world and typically provide budget projections, budget risk analyses, estimates of policy changes, impact assessments, flow of funds analyses, macro-trend analysis, and financial analysis where prospective policies can be independently costed.

PBOs are different from Fiscal Councils, in that fiscal councils occupy a watchdog function, evaluating the health of the economy generally and assessing compliance with constitutionally-mandated fiscal rules. The proposed IPBO would:

- Ensure a more inclusive process with greater Parliamentary engagement;
- Promote a shared understanding of both the parameters within which policy is framed and the key policy priorities; and
- Facilitate continuous engagement and accountability over the full-year regarding budgetary outputs.

The establishment of an IPBO will allow parliament more consistent access to a suite of models for policy costings and would relieve the Departments of some of the difficulties associated with these costings, because the IPBO will be independent and a part of the Oireachtas, while the Department of Finance is bound to serve the Government. Oireachtas committees would also benefit from the IPBO since members of the Office would be required to appear before the Committees to discuss the costings of various policies.

The Sub-Committee on Dáil Reform has recently published a report which addresses the establishment of an IPBO<sup>37</sup>. Specifically, the sub-Committee has requested that the Select Committee on Arrangements for Budget Scrutiny bring forward a detailed proposal with a view to ensuring that the IPBO will be fully operational by spring 2017. Further, the sub-Committee recommends that the IPBO should be established on a statutory basis in order to underpin its independence.

In order to be an effective Office, the Office must have unequivocal access to budgetary information and models. An information protocol will also be required to provide transparency and clarity on information requests it receives.

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**Recommendation:** Establish on a statutory basis the independent Irish Parliamentary Budget Office to ensure more parliamentary engagement in fiscal policy making and to assist in the overall goal of maintaining fiscal sustainability.

**Responsibility:** Department of Public Expenditure and Reform

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### Rainy Day Fund

In addition to adherence to the fiscal rules, measures are required to ensure that the public finances remain on a sustainable path. In 2015 the NCC recommended that a fund to deal with future liabilities be created and welcomes the announcement of the Rainy Day Fund in the *Programme for Partnership Government*. Details on how the fund will be resourced and structured or the planned amount to be allocated to the fund each year after meeting the expenditure and tax commitments elsewhere in the programme are not specified. Details on how the Fund would interact with the

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<sup>36</sup> OECD, Review of Budget Oversight by Parliament: Ireland, Preliminary Draft, Public Governance and Territorial Development Directorate - Budgeting and Public Expenditures, Autumn 2015

<sup>37</sup> Sub-Committee on Dáil Reform, Final Report of the Sub-Committee on Dáil Reform, 24th May 2016

Ireland Strategic Investment Fund and the investment strategy so as to ensure that the resources dedicated to the Rainy Day Fund yield a return are also required.

In its Summer Economic Statement, the Department of Finance stated:

*"Once the MTO is achieved in 2018 it is proposed to retain within the Exchequer of the order of €1 billion of the available fiscal space for 2019 as a contingency reserve which, if not deployed in the event of an unanticipated adverse shock to the economy, will be remitted to the rainy day fund towards the end of that year. While the amounts currently set out are provisional, in subsequent years, provided the MTO is maintained, a similar amount will be remitted to the rainy day fund which provides a prudent counter-cyclical buffer. "*

The purpose of the Rainy Day Fund should be to support counter-cyclical fiscal policy. It could also help the Government to avoid the need for forced fiscal consolidation in the event of a sudden loss of financial market access.

The Department of Finance has committed to producing a paper for consultation with the Oireachtas in late 2016 - early 2017 outlining the proposed operational modalities, including *inter alia* the trigger for deploying the fund. The NCC welcomes this commitment in line with the best-practice in performance budgeting (above).

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**Recommendation:** Develop detailed proposals and operational guidelines to facilitate the establishment of the ring-fenced "Rainy Day Fund" to serve as a counter cyclical buffer to economic and financial shocks.

**Responsibility:** Department of Finance, NTMA, Ireland Strategic Investment Fund

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### Taxation System

Tax reforms have contributed to Ireland's recent fiscal adjustment, but there is further scope to improve the efficiency of the tax system and to ensure that the tax system is as supportive of competitiveness, growth, entrepreneurship and job creation as possible, whilst having regard to wider societal objectives. Maintaining a growth and entrepreneurship-friendly taxation system, whilst simultaneously broadening the tax base, is critical to maintaining existing levels of employment and creating new jobs, as well as facilitating investment in infrastructure, education and R&D. In essence, efforts to increase Government revenue should reflect the OECD tax hierarchy for growth<sup>38</sup>.

From an enterprise perspective, it is important that the taxation system is balanced in a manner that supports both the indigenous and FDI sectors. The tax system should support and reward risk taking, investment and entrepreneurship.

From an individual perspective, throughout the boom years of the early and mid-2000's large numbers of the workforce were removed from the personal tax net. Following the onset of the financial crisis and economic recession, the need to broaden the tax base was recognised and a range of measures were introduced to achieve this – including the introduction of the Universal Social Charge, residential property taxes, and water charges. As the economy has recovered, we have already seen a resumption of policies that result in a narrowing of the tax and revenue base (e.g. through increases in PAYE and USC bands, the suspension of water charges). By 2016 over 703,000 earners (or 29 per

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<sup>38</sup> Empirical work by the OECD suggests a tax and economic growth hierarchy with recurrent taxes on immovable property being the least distortive tax instrument in terms of reducing long-run GDP per capita, followed by consumption taxes and other property taxes as well as environmentally-related taxes, personal income taxes and corporate income taxes. As referenced in O'Connor (2013), improvements in tax structure and design can reap significant dividends in terms of increased economic efficiency and greater fairness. See O'Connor, B., The Structure of Ireland's Tax System and Options for Growth Enhancing Reform, Economic and Social Review, Vol. 44, No. 4, Winter, 2013



cent of earners) had been removed from the personal tax net<sup>39</sup>, while 36 per cent of earners were exempt from income tax<sup>40</sup>. To ensure the sustainability of the public finances, it is important that the principle of maintaining a broad tax base is applied.

Fiscal policy could better support job-rich growth by rebalancing the tax mix away from direct taxes and by widening the tax base so that a greater number of workers contribute in an equitable way, thereby reducing the burden on middle-income households. Rebalancing the tax mix would boost sustainable revenues and support job creation.

Compared to our EU peers, Ireland's tax system has a higher reliance on more distortionary direct taxes and is less reliant on property and wealth taxes; indirect taxes in Ireland are around the EU average. In particular, personal income taxation (PIT) has a relatively narrow base (about 30 per cent of households are exempted) and a relatively rapid progressivity (i.e. the top marginal rates are among the highest in the OECD). This places a large tax burden on middle income households, weakens the case for second earners to participate in the labour market, creates welfare traps for low-skilled workers, and discourages high-skilled workers from migrating to Ireland. Potential revenue losses from any reduction in PIT could be compensated for by reducing the number of products with reduced and zero VAT rates and by increasing the yield from property taxes.

Of course, indirect taxes such as VAT are regressive and so from a fairness perspective, the overall or cumulative impact of changes in taxation on household income need to be considered.

Piecemeal reform of taxes has resulted in increased complexity and is likely to continue to generate anomalies. In this regard, a medium-to-long term perspective on taxation is required<sup>41</sup>. Such a perspective would help to clearly define the objectives being pursued through our tax system, and should consider whether current structures are fit for purpose. As part of such a process, there is a need to take an overview of the whole of the tax system, rather than focusing on individual elements of taxation (such as personal taxation). The interaction and impact of the full range of direct and indirect taxes on individuals and companies must be considered. Finally, there must be recognition of the link between the overall tax burden on citizens and enterprise, and the level and quality of services provided by the State in return.

In light of these factors, the establishment of a tax committee to review and simplify aspects of the taxation system and to provide a roadmap for reform has merit<sup>42</sup>.

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**Recommendation:** Establish a tax committee to review, simplify, and bring coherence to Ireland's overall tax system over the medium term.

**Responsibility:** Department of Finance

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<sup>39</sup> Irish Taxation Institute, Pre-Budget Submission 2017, August 2016

<sup>40</sup> Department of Finance, Income Tax Reform Plan, July 2016

<sup>41</sup> The recently published Income Tax Reform Plan is noted, and is a welcome development in this regard. See Department of Finance, Income Tax Reform Plan, July 2016

<sup>42</sup> The Tax Strategy Group is an interdepartmental committee chaired by the Department of Finance, with membership comprising senior officials and advisors from the Departments of Finance; Taoiseach; Jobs, Enterprise and Innovation; Social Protection and the Revenue Commissioners. Papers on various options for the Budget and for the medium and longer term are prepared for the Tax Strategy Group. Its terms of reference are to (i) examine and develop proposals for measures in the areas of taxation, PRSI and levies, for Budget and Finance Bill within agreed Government parameters for the overall Budget position and in the context of the framework of a medium term and longer term strategy set out in the Government's programme, and (ii) examine the strategic approach for a general social welfare package and to assess the interaction of income tax/PRSI/levies proposals with social welfare proposals including child income support, and in particular the impact of this interaction on the labour market and income distribution.

### Income Tax

A competitive income tax regime is essential to attract and retain individuals in Ireland and more generally to encourage people to remain in or return to the labour market. Notwithstanding the reductions in recent budgets, the increase in labour taxes (i.e. income tax, PRSI and the USC) over the course of the economic recession eroded competitiveness and weakened the incentive to work<sup>43</sup>. High labour taxes increase the cost of labour and the replacement rate (i.e. high taxes make work less attractive vis-à-vis social welfare), reduce take home pay and domestic demand, negatively impact on the incentive to work additional hours, and risk stimulating the informal economy.

The PfPG committed to the development of a medium-term income tax reform plan. The purpose of the plan is to review Ireland's system of personal taxation as a whole, to consider the socio-economic impacts of personal taxation, and to examine options for future reform within the personal tax system.

Income related taxes are composed of three separate but concurrent taxation bases (i.e. the income tax base, the USC tax base and the PRSI tax base), each of which is administered with different inclusions and exclusions of income sources<sup>44</sup>. The European Commission have already noted that Irish labour taxation lacks simplicity. Further, the piecemeal changes to and exemptions from the Universal Social Charge implemented over recent years have undermined the original purpose of its introduction<sup>45</sup>. It may now be opportune to reconsider the entire structure of personal taxation in Ireland, and to develop a roadmap towards implementing a more simplified system of taxes and charges, incorporating income tax, PRSI and the USC that better supports employment and job creation<sup>46</sup>.

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**Recommendation:** Continue to reform and simplify the current regime of taxes and charges on employment, specifically to further encourage the take-up of employment opportunities and job creation, whilst simultaneously maintaining a broad personal tax base. Anomalies in relation to PAYE and the USC should be removed to support the self-employed, job creation and entrepreneurship.

**Responsibility:** Department of Finance

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One of the key issues in relation to the competitiveness of our labour taxation regime is the level at which employed individuals start paying the higher rate of income tax (€33,800 for single individuals). This is very low relative to other countries, and as a consequence, the higher rate of income tax impact individuals earning less than the average wage (€36,626 in Q4 2014)<sup>47</sup>. Prior to Budget 2016, this meant that marginal rates (i.e. the income tax, USC and PRSI paid on an individual's last euro of income) were in excess of 50 per cent for individuals earning €33,800 per annum.

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<sup>43</sup> It should also be noted that in 2007 and 2008, income taxes were significantly reduced. As a result of the reversals in 2009 onwards, effective income tax rates in 2016 are approximately the same as in 2005.

<sup>44</sup> Collins notes that, driven by incremental policy reforms, the latter two bases have become much closer and are both more comprehensive than the income tax base with continues to accommodate a myriad of credits, allowances, exemptions and tax. See Collins, M., Taxes and Income Related Taxes Since 2007, NERI WP 2015/No 25, March 2015

<sup>45</sup> When first announced, the USC offered the possibility of simplifying the Irish tax structure – replacing the income levy, the health levy, and employee PRSI with a single charge that would be levied across a wider base. Note, the USC, unlike PRSI is charged on all sources of income, not just income from employment or self-employment.

<sup>46</sup> The Irish Tax Institute point out that there are currently 3 personal tax charges, each with different entry points, 10 rates, 15 bands, and 22 personal tax credits, adding up to 53 different moving parts. ITI also point out that the nine consecutive Budgets between 2009 and 2016 introduced over 50 tax changes that impacted Ireland's personal tax system. See Irish Taxation Institute, Perspectives on Ireland's Personal Tax System: A Medium to Long Term Approach, September 2016

<sup>47</sup> The tax burden in Ireland is comparatively low at income of up to 125 per cent of average earnings. It then surpasses the UK and US at c.125 per cent and 150 per cent respectively and surpasses the comparative French tax burden at c.210 per cent of average earnings, but still remains below the personal tax burden in Denmark and Germany at that point. This comparison suggests that Irish employers could face difficulties in seeking to attract mobile international talent from certain competitor jurisdictions, all other factors being equal.

## Ireland's Competitiveness Challenge 2016

As a result of changes introduced from 1<sup>st</sup> January 2016, the marginal rate for those earning up to €70,043 has dropped to 49.5 per cent. However, with the marginal rate of taxation remaining above 50 per cent for employees earning in excess of €70,044, the headline tax rates in Ireland still remain comparatively high by international standards.

Mirroring the OECD hierarchy of taxation, economic growth would be boosted by lowering the burden of taxation on labour – in particular, by reducing the maximum marginal rate (income tax, USC and PRSI). Over time, this could be achieved by moving the entry point to the top marginal income tax rate above the average wage, reducing the marginal rate or through a combination of both measures. At the same time, any changes to labour taxes must take account of the overall taxation burden on individuals and households (reflecting the importance of both direct *and* indirect taxation).

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**Recommendation:** Review income taxes (e.g., credits, thresholds, rates, etc.) to support improvements in after-tax income, enhancing the incentive to work while simultaneously protecting labour cost competitiveness. Building on the changes in Budgets 2015 and 2016, the entry point to the top marginal income tax rate should be increased and maximum marginal rates for all employees should be brought below 50 per cent.

**Responsibility:** Department of Finance

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The *Programme for Partnership Government* also commits to the continued phasing out of the USC, a proposal targeted at middle income earners. The USC is a progressive tax. Revenue generated through the USC accounts for over 9 per cent of all tax revenue and, therefore, phasing it out would amount to a significant narrowing of the current tax-base. This is inconsistent with another commitment contained in the PFG to develop Ireland as a “Social Economy around a Stable and Broad Tax Base”.

The phasing out of the USC could cost the Exchequer between €1.78bn and €1.86bn<sup>48</sup>. If the USC is phased out, the Council believes it is imperative that the revenue foregone be replaced with revenue from growth-friendly sources such as taxes on consumption (i.e. targeted environmental taxes, for example) and property. A Department of Finance working paper estimated that a revenue neutral shift of €1 billion from labour taxes to property taxes (see below) would result in GDP being 0.38 per cent higher and employment 0.43 per cent higher after 5 years<sup>49</sup>.

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**Recommendation:** Outline how the revenue foregone from the abolition of the USC would be replaced in a growth and employment friendly manner, consistent with the principle of broadening the tax base.

**Responsibility:** Department of Finance, Tax Strategy Group

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### Corporation Tax

Long term certainty, transparency and predictability with regard to the corporate tax regime is critical in informing the long term investment plans of inward investors in Ireland, and is a key determinant of the competitiveness of all Irish based firms trading internationally. Ireland also needs a competitive corporation tax offering to attract and develop knowledge-based investment, related to research and development and intellectual property.

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<sup>48</sup> Department of Finance, Income Tax Reform Plan, 2016

<sup>49</sup> O'Connor, B., The Structure of Ireland's Tax System and Options for Growth Enhancing Reform, Economic and Social Review, Vol. 44, No. 4, Winter, 2013

Corporation tax receipts are currently well ahead of expectations, with the outturn more than €500 million above profile in the first half of 2016. The growth in corporate tax receipts in part reflects the more robust trading environment: despite the well-publicised dependence on a small number of sectors and a small number of companies as the primary sources of revenue, analysis shows that the growth in corporation tax receipts in 2014 and 2015 was broad based in nature and not solely reliant on foreign owned multinational firms – more companies were paying corporation tax and average payments were higher than in previous years<sup>50</sup>.

The Government has signalled, however, that a significant portion of the over-performance in total taxes is being driven by large unexpected payments as well as timing issues, some of which are expected to unwind as the year progresses. However, €300 million of the over-performance can be attributed to a number of large unexpected payments from a small number of companies, which could be repaid over the course of the year. This highlights the transitory nature of corporation tax and the Irish Fiscal Advisory Council has cautioned recently that this revenue source should be treated with greater care than other tax sources<sup>51</sup>.

Despite increasing competition and changing FDI composition, Ireland remains highly competitive as a location for new and existing FDI, and remains an attractive location from which to do business. As a small peripheral island economy, dependent on internationally mobile capital flows, it is critical that Ireland's firm level offerings and suite of tax offerings for enterprise remain competitive and best in class. Despite intense international competition for globally mobile investment, the Irish corporation tax regime remains competitive and stable<sup>52</sup>. However, the gap between Ireland's 12.5 per cent tax rate and rates in OECD countries is narrowing. While Ireland's corporate rate has remained consistent over time, many countries have reduced their rates, notably the UK, Japan and Finland.

Policies which increase investment in R&D and maintain cost competitiveness are particularly important for Ireland's attractiveness to FDI. In this regard, the introduction of a new "best in class" knowledge development box and a broadening of the R&D tax credit is designed to improve Ireland's FDI tax offering and facilitate investment in R&D by Irish based enterprises. The 'knowledge development box' was introduced on 1<sup>st</sup> January 2016. It offers a reduced corporate tax rate of 6.25 per cent for qualifying incomes from certain types of intellectual property such as patents and copyrighted software, which arise from R&D activity, carried out by the taxed entity or outsourced to unrelated parties. The 'knowledge development box' is intended to attract international projects and 'knowledge based capital'. The measure is in line with the modified approach developed under the OECD Base-Erosion and Profit-Shifting (BEPS) project, with which all Member States agreed to comply in the EU's Code of Conduct Group on Business Taxation. In this regard, the Council welcomes Ireland's active engagement in the BEPS project – it is important that Ireland continues to be a strong proponent of, and active participant in, this international process<sup>53</sup>. By aligning our corporation tax regime with international standards, we maintain our relationships with key partner countries and provide greater certainty to taxpayers.

It is important that firms are aware of the both the R&D Tax Credit and the KDB, and that the practicalities of using both schemes are clear and understandable for users. In this regard, a recent evaluation of the R&D Tax Credit notes

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<sup>50</sup> Analysis shows that 10 companies accounted for 41 per cent of corporation tax revenue in 2015, while approximately 80 per cent of total corporation tax revenue is generated by foreign owned firms. See Revenue, An Analysis of Corporation Tax Receipts in 2014-2015, April 2016

<sup>51</sup> Irish Fiscal Advisory Council, Challenges Forecasting Irish Corporation Tax, September 2016

<sup>52</sup> Ireland's headline corporation tax rate of 12.5 per cent has not changed since it was introduced from 1 January 2003. Over the past few years a number of changes to our regime have been implemented, notably in the areas of company residence and in enhancements to our innovation offerings. For example, the Finance Act (No. 2) 2013 and Finance Act 2014 saw amendments to the Irish company resident rules to address situations where multinational enterprises ('MNEs') were exploiting the differences in residency rules in different jurisdictions to minimise their tax bills.

<sup>53</sup> The importance of maintaining our active and full engagement in the OECD BEPS project is acknowledged by the Department of Finance who note that "as a small country with an open economy, we must keep pace with this international movement for change". See Department of Finance, An Update on Ireland's International Tax Strategy, October 2015

that "to achieve the stretch targets set in Innovation 2020 continued promotion of the tax credit and direct in-company R&D support for companies will be critical"<sup>54</sup>.

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**Recommendation:** Continue to develop our suite of tax offerings to ensure it is internationally competitive for enterprise and attuned to evolving sectors and activities in the context of continued engagement with the OECD's Base Erosion and Profit Shifting project. A competitive corporation tax rate, an attractive and stable tax regime and a strong reputation and commitment to transparency are all crucial in this regard.

**Responsibility:** Department of Finance, Tax Strategy Group

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### Value Added Tax (VAT)

VAT is a consumption tax, charged on most goods and services traded for use or consumption in the EU. It is levied on the 'value added' to the product at each stage of production and distribution, and is intended to be neutral (i.e. businesses are able to reclaim any VAT that they pay on goods or services)<sup>55</sup>. Ultimately, the final consumer should be the only one who is actually taxed. The VAT system in the EU is governed by a common legal framework (the VAT Directive) which imposes a minimum standard VAT rate of 15 per cent, above which Member States are free to set their own national VAT rates.

The VAT policy gap is defined as the difference between the amount of VAT actually collected and the VAT Total Tax Liability (VTTL). The VTTL is an estimated amount of VAT that is theoretically collectable based on the VAT legislation and ancillary regulations.

A recent EU study calculates the VTTL for each country on the basis of national accounts by mapping information on standard, reduced rates and exemptions onto data available on final and intermediate consumption, along with other information provided by Member States<sup>56</sup>. Only six Member States had bigger VAT policy gaps than Ireland in 2014. Potential exists, therefore, for additional revenue collection.

The current VAT system in Ireland is very complex and there are currently many different applicable rates: a standard rate of 23 per cent<sup>57</sup>; a reduced rate of 13.5 per cent<sup>58</sup>; a reduced rate of 9 per cent<sup>59</sup>; an agricultural rate of 4.8 per cent<sup>60</sup>; a nil rate of 0 per cent<sup>61</sup>; and exempt from VAT<sup>62</sup>.

There is, therefore, further room to improve the growth-friendliness of the tax regime without affecting the overall tax burden on the economy (i.e. the tax to GDP ratio). However, there appears to be no process for systematically evaluating the costs and benefits of reduced VAT rates in Ireland, in sharp contrast with the numerous reviews of other tax expenditures conducted in 2015. In light of the complexity of the current system and the various exemptions which exist, the NCC is recommending that a review of VAT be conducted to outline the rationale for different VAT treatment of goods and services, with a view to creating a more growth-friendly taxation system. The application of

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54 Department of Finance, Economic Evaluation of the R&D Tax Credit, October 2016

55 The "value added" means the difference between the cost of inputs into the product or service and the price at which it is sold to the consumer.

56 Center for Social and Economic Research, Study and Reports on the VAT Gap in the EU-28 Member States: 2016 Final Report, August 2016

57 All goods and services other than those specified as being exempt, liable at the zero rate or liable at the various reduced rates.

58 Examples of goods and services liable for VAT at 13.5 per cent include certain fuels, and building services.

59 Examples of goods and services liable for VAT at 9 per cent include catering and restaurant services, hotel lettings, cinemas tickets and hairdressing services.

60 Examples liable for VAT at 4.8 per cent include the sale of livestock and greyhounds.

61 Goods and services which attract the zero rate of VAT include exports, intra-Community supplies of goods to VAT-registered persons in other EU Member States, certain food and drink, oral medicine, certain books and booklets and clothing and footwear appropriate to children under 11 years of age.

62 Exempt goods and services consist principally of financial, medical and educational activities as well as admissions to and promotion of certain live theatrical and musical performances. There is a major difference between zero rated supplies and exempt supplies. The difference is that taxable persons making zero rated supplies are entitled to a refund of VAT on business purchases whereas suppliers of exempt supplies are not entitled to a refund of VAT on business purchases.

reduced rates should demonstrably achieve defined objectives, rather than simply represent a transfer of tax revenue from the State to individual interest groups.

As noted above, there may also be merit in extending this review process on an ongoing basis to other taxation areas.

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**Recommendation:** Review VAT exemptions and outline the case for current reduced rates and exemptions. Consider the merits of further standardisation of rates to allow for reductions in more distortionary taxes such as those on labour.

**Responsibility:** Department of Finance

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### Property Tax

The Local Property Tax (LPT) is an annual self-assessed tax charged on the market value of all residential properties in the State. The LPT came into effect in 2013. The revenue raised is used to fund the provision of services by local authorities. Such services currently include public parks; libraries; open spaces and leisure amenities; planning and development; fire and emergency services; maintenance and cleaning of streets; and street lighting.

A revaluation of self-assessed property values used to calculate local property tax liabilities was initially planned for 2016, but has been delayed by three years to November 2019. This decision represents a lost opportunity to broaden the tax base as residential property prices have increased substantially since the first self-assessment in 2013, especially since the European Commission recently has found no evidence of over-valuation in residential property sector. The Council believes there is no rationale for a prolonged freeze in revaluations.

Revenues from immovable properties in Ireland are below the EU average. Such revenues amounted to 1 per cent of GDP in 2014, below the EU average of about 1.6 per cent of GDP. Moreover, a number of exemptions, including for newly developed houses, is to be extended. Recurrent taxes on immovable property are considered to be among the taxes least harmful to growth. An increase in the share of revenue from a recurrent tax on residential property would, in the Council's view, reduce the cyclical sensitivity of government revenues and encourage more efficient allocation of land resources (See Chapter 4).

It should be noted that, within the current valuation of property prices, local authorities have leeway to increase or decrease those charges by 15 per cent locally (having regard to local circumstances and demand). Notwithstanding the freeze in revaluations, some local authorities have opted to increase their property tax rates within these bands as a means to fund local projects and deliver enhanced services, in light of the increased demands for such services in a growing economy.

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**Recommendation:** Expedite the revaluation of property prices in relation to the residential property tax.

**Responsibility:** Department of Finance

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### Environmental Taxes

An environmental tax is a tax on something that has a proven, specific negative impact on the environment. Environmental taxes are seen as one of the least distortionary taxes, and as such may offer an alternative to more distortionary labour taxes. According to the Tax Strategy Group "recent taxation developments such as the

introduction of a carbon tax and linking vehicle registration tax and motor tax to emissions have resulted in reduced levels of emissions<sup>63</sup>. Additional environmental taxes could also provide incentives to drive behavioural change to help Ireland meet its environmental commitments outlined in Chapter 1.

In the ten years from 2006 to 2015, environmental taxes in Ireland have increased by 10 per cent from €4.5bn to €4.9bn, and accounted for 8.2 per cent of total taxes collected over the period. Despite this, Ireland's taxes on pollution and resources are just one third of the EU average<sup>64</sup>.

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**Recommendation:** Consider the scope to make greater use of environmental taxes to reduce the tax burden on labour, to incentivise employment creation, and to help meet Ireland's environmental commitments.

**Responsibility:** Department of Finance

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<sup>63</sup> Tax Strategy Group, Climate Change Paper: Energy and Environmental Taxes and Vehicle Registration Tax, TSG 16/03, July 2016

<sup>64</sup> See [www.publicpolicy.ie/environmental-and-income-taxes/](http://www.publicpolicy.ie/environmental-and-income-taxes/)

## Chapter 3: Capital Investment in Physical Infrastructure

### Why Capital Investment Matters for Competitiveness

The availability of competitively priced, high quality physical economic infrastructure (i.e. energy, telecommunications, roads, public transport, airports, waste and water systems) and related services are critical to support competitiveness. The efficiency and effectiveness of Ireland's economic infrastructure networks have a strong bearing on the competitiveness of indigenous enterprises and as a driver of inward investment. The quality of physical economic infrastructure also has tangible effects on productivity growth and improvements in living standards and quality of life.

Increased public infrastructure investment raises output in the short term by boosting demand and in the long term by raising the economy's productive capacity. The IMF estimates an increase of 1 percentage point of GDP in investment spending can increase output by about 0.4 per cent in the same year and by 1.5 per cent four years after the increase in investment<sup>65</sup>. Because investment projects tend to be large-scale and costly, these investments can have a long lead-in time and efficiency and effectiveness in terms of project selection and appraisal is essential. From a policy perspective, effective planning, delivery and financing is critical to reap the dividends from investment in the longer term.

### Current Context

In the wake of the global financial crisis, capital investment levels across the OECD dropped significantly and recovery to date has been modest. In countries badly hit by the crisis, such as Ireland, exchequer capital investment was severely reduced to meet fiscal consolidation objectives and remains below pre-crisis levels. Although Irish investment levels are recovering, over the medium term, capital investment is projected to remain low relative to pre-crisis levels. The relatively low levels of net investment projected over the medium term represent a significant challenge in light of demographic pressure, EU budgetary commitments and clear infrastructure deficits. The key issue faced by the Government in seeking to address Ireland's infrastructure deficit is the fiscal space available to the Government under the fiscal rules of the Stability and Growth Pact which restrict the Government's ability to increase expenditure, including on capital projects. As the economy continues to demonstrate strong growth, developing Ireland's physical infrastructure stock while complying with the EU's fiscal rules is perhaps the essential challenge to safeguarding future competitiveness.

As set out in the Chapter Two the Council supports the Government's commitment to adhering to the provisions of the Stability and Growth pact. However, there are provisions in the fiscal rules that are designed to promote public investment. Within the expenditure benchmark pillar of the fiscal rules, capital investment in respect of capital formation is granted favourable treatment. It is essential that Ireland avails of these provisions in a manner compatible and in adherence with the rules to support productive investment.

The 2015 Capital Plan "Building on Recovery: Infrastructure and Capital Investment 2016-2021", committed the Exchequer to €27 billion of expenditure on capital projects over the lifetime of the Plan. The aim is to supplement this with investment from the wider semi-state sector (€14.5 billion), and Public Private Partnerships (PPPs) (€500 million), bringing total state investment to €42 billion between 2016 and 2021. The 2016 Programme for a Partnership

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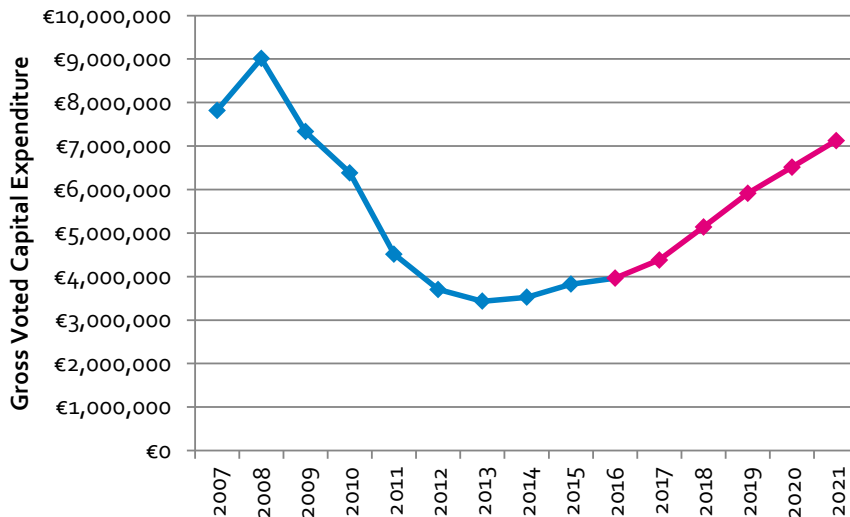
<sup>65</sup> IMF, World Economic Outlook, 2014



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Government commits to a review of priorities and investment levels in the context of an early Mid-Term Review of the Capital Plan and Budget 2017 announced this will commence immediately. In addition, in the 2016 Summer Economic Statement the Government has also provided for a cumulative, additional €5 billion in exchequer capital investment up to 2021 in the areas of transport, broadband, education, health and flood defences, to accelerate delivery of priority infrastructure requirements. The increasing allocation for capital expenditure is illustrated by the pink line in Figure 3.1.

Figure 3.1 Exchequer Voted Capital Expenditure and projections to 2021<sup>66</sup>



Source: Department of Finance

The Council believes that to maintain and enhance Ireland's competitiveness performance in the medium and long term and to ensure future growth prospects are not constricted, capital investment (as a percentage of GDP) should increase to match investment levels in competitor countries that are at a similar stage of infrastructural development. Table 3.1 illustrates the projected scale of Government investment.

Table 3.1: Exchequer Capital Investment as a proportion of GDP, 2016 to 2021

€million	2016	2017	2018	2019	2020	2021
Gross voted capital (€million)	3,965	4,380	5,140	5,915	6,515	7,125
GDP (nominal, €million) <sup>67</sup>	231,400	243,900	258,000	271,600	285,400	299,100
<i>Proportion of GDP</i>	1.71%	1.80%	1.99%	2.18%	2.28%	2.38%

Source: Department of Finance

Table 3.2 illustrates the scale of Government investment across a range of developed, small economies – from this table it is clear that Ireland is investing significantly less than many of our peers and countries against whom we compete for trade and investment. This will remain the case, even allowing for the increased capital allocation outlined

<sup>66</sup> Department of Finance, Summer Economic Statement, June 2016

<sup>67</sup> *ibid*

in the new 2016-2021 Capital plan. Capital investment (as a percentage of GDP) should at least mirror levels in competitor countries that are at a similar stage of infrastructural development.

Table 3.2: General government gross fixed capital formation (GFCF) as a % GDP, 2015

	GDP (€bn)	GDP per capita (€)	General government GFCF (% GDP)
Ireland	€196.323	€42,229	2.02%
Portugal	€178.113	€17,228	2.32%
Austria	€334.650	€38,966	2.89%
Switzerland	€620.731	€75,601	3.00%
Netherlands	€663.094	€39,155	3.52%
Denmark	€264.263	€46,653	3.83%
Finland	€207.166	€37,750	4.11%
Sweden	€435.737	€44,406	4.46%

Source: European Commission, AMECO Database

The Council supports the view articulated in the Summer Economic statement that “creating deeper infrastructural linkages between the stronger growth hubs and other parts of the country will help to spread growth more evenly and hence address some of the regional imbalances that have emerged in recent years”. The type of infrastructure invested in matters, as do the combinations of infrastructure, if investment in infrastructure is to be effective. Ensuring coherent and clear linkages between the objectives set out in the National Planning Framework (NPF – see Chapter 1) and the objectives of the Mid-Term Review of the Capital Plan is critical.

### How Ireland Performs

In common with most other OECD countries, general Government capital expenditure in Ireland declined significantly as a result of the crisis and remains relatively weak. Following a peak investment of 5.2 per cent of GDP in 2008, public investment fell to a low of 1.8 per cent of GDP in 2013 before slightly recovering in 2014. While recent capital expenditure commitments in Ireland are welcome – present levels of investment are insufficient to close the economic infrastructure gap between Ireland and our key competitors which still persist. As a percentage of GDP, Ireland's inland infrastructure expenditure declined from 0.8 per cent in 2008 to 0.4 per cent in 2013 and was well below the OECD and euro area averages (0.8%).

Ireland's diminished investment in infrastructure is reflected in our low scores in relation to the perception of overall infrastructure quality. A range of international benchmarks, mostly qualitative in nature, are available comparing the stock and quality of infrastructure in Ireland against our key competitors. Ireland continues to perform poorly in terms of perceptions regarding the overall quality of infrastructure according to assessments by the World Economic Forum (WEF) and the Institute for Management Development (IMD).

Reflecting a period of sustained capital investment by the State, there was a strong improvement in perceptions up until 2010. Ireland's overall infrastructure quality rating as benchmarked by the WEF fell over the five years to 2015 and Ireland's rating is now below the OECD average. Ireland is rated as the 24<sup>th</sup> best country globally by the IMD in terms of infrastructure quality and is ranked 37<sup>th</sup> for investment in telecommunications as a percentage of GDP. Ireland is ranked 57<sup>th</sup> globally for investment in telecommunications and scores very poorly for fixed telephone tariffs (55<sup>th</sup>),

## Ireland's Competitiveness Challenge 2016

mobile phone costs (57<sup>th</sup>), and fixed broadband tariffs (45<sup>th</sup>), connectivity of people and firms (52<sup>nd</sup>) and communications technology (49<sup>th</sup>). Ireland ranks 50<sup>th</sup> in relation to electricity costs for industrial customers and access to water (51<sup>st</sup>) is also perceived poorly. Perceptions about the quality of air transport have also deteriorated – Ireland's ranking fell from 9<sup>th</sup> in 2014 to 22<sup>nd</sup> in 2015. The adequacy of water transportation has fallen from 13<sup>th</sup> to 29<sup>th</sup>. Perceptions on the adequacy of infrastructure maintenance and development have also fallen from 17<sup>th</sup> to 30<sup>th</sup>.

Ireland had the third highest percentage increase in population (14%) between 2004 and 2014 in the EU. The combined effect of natural increase and negative net migration resulted in an overall increase in the population of 3.7 per cent since 2011. This increase in population serves to increase the demands on existing infrastructure and provides an important context for the development of future capital expenditure plans.

### Policy Challenges and Recommendations

Economic growth, demographic pressures and a sustained period of underinvestment in infrastructure mean there is a manifest and urgent need to increase investment in essential economic infrastructures. The scope to improve physical infrastructure stock and improve the effectiveness of delivery in the medium term as set out in the Capital Plan must be guided by adequate levels of investment and by identifying and prioritising those investments which contribute most to Ireland's long term competitiveness. Investment must also address identified enterprise needs and bottlenecks.

However, as noted in last year's Challenge Report and by other bodies such as the Irish Fiscal Advisory Council<sup>68</sup>, the provision for investment in the Capital Investment Plan 2016-2021 will focus largely on maintenance and upgrading of existing stock and will only facilitate a limited increase in the stock of public capital over the medium term. Delays in delivering planned infrastructure compound current bottlenecks, increase congestion costs, and undermine the competitiveness and productivity of enterprise. The Council welcomes the commitment from Government to undertake an early Mid-Term Review of the Capital Plan, with immediate effect following Budget 2017, which is essential to take stock of progress and in particular to reassess the scope and scale of investment, from competitiveness perspective taking economic growth and fiscal commitments into account. The Council considers it vitally important that the priorities identified in the Mid-Term Review are informed by the objectives set out in the NPF.

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**Recommendation:** Avail of the provisions within the expenditure benchmark pillar of the EU fiscal rules to fund capital investment. Use of these provisions should be in a manner compatible with and in adherence to the rules of the Stability and Growth Pact.

**Responsibility:** Department of Finance, Department of Public Expenditure and Reform

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**Recommendation:** Increase the allocation for capital investment in physical and knowledge capital to support competitiveness, in the context of the Mid-Term Review of the Capital Plan. Ensure that coherent and clear linkages exist between the objectives set out in the National Planning Framework and the priorities identified in the Mid-Term Review of the Capital Plan.

**Responsibility:** Department of Public Expenditure and Reform

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68 IFAC, Public Capital: Investment, Stocks and Depreciation, 2016

### Planning, Evaluation and Frameworks for Capital Investment delivery

Identifying and prioritising capital investment is a complex process involving short, medium and long term considerations. In ascertaining the scale and configuration of infrastructural requirements, a wide range of factors such as the existing level and composition of capital stock; the social and economic returns from investment, demographic and economic growth projections and the scale of the deficit need to be assessed. The scale of public investment in infrastructure is also reliant on a number of critical factors, including the broader context of the total level of investment in the economy, the condition of the public finances, borrowing costs and Ireland's commitments under the Stability and Growth pact.

The impact of investment critically depends on its efficiency. Assessing the efficiency of investment requires methodologies to identify projects and programmes with the most favourable cost-benefit ratios. In terms of infrastructure planning, Ireland has a somewhat fragmented institutional framework. IMF research comparing the value of public capital (input) and measures of infrastructure coverage and quality (output) suggests improvements in public investment management (PIM) could significantly enhance the efficiency and productivity of public investment<sup>69</sup>.

In the context of the Mid-Term Review of the Capital Plan, there is scope to review how best to facilitate the efficient roll-out of essential infrastructures by ensuring that a more coherent and comprehensive approach across government departments, agencies and local authorities is adopted. At present responsibility for planning, delivery and maintaining infrastructure is shared between government departments, regulators, local and regional authorities, state agencies and state-owned providers of infrastructure. Public-Private Partnerships (PPP) also continue to play a role in infrastructure planning, investment, and delivery, as do private sector companies (e.g. in the waste and telecoms sectors). Deficiencies in co-ordination and fragmented planning and coordination can contribute to cost overruns and delays, duplication of resources and weaken the ability to prioritise projects and locations for capital investment. Ensuring an effective, integrated and coherent approach to State led infrastructure planning and delivery could facilitate improved efficiency and enhance the effectiveness of capital investment at minimum cost.

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**Recommendation:** Review how other advanced economies coordinate and deliver capital investment and identify best practice in terms of the institutional framework for capital infrastructure investment.

**Responsibility:** Department of Public Expenditure and Reform, Irish Government Economic and Evaluation Service

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Investment in infrastructure is not risk free, and different investments have different impacts. Effective project selection is essential to ensure investment is productive, achieves the desired economic or social objectives, and represents value for money. From the Council's perspective, public capital investment both in the maintenance of existing stock and new investment must be prioritised to maximise the impact on competitiveness. It is critical that public capital investment decisions prioritise investment based on effective impact and long-term competitiveness gains.

The Public Spending Code introduced by the Department of Public Expenditure and Reform in 2013 is designed to ensure that a comprehensive and uniform approach is taken to project appraisal and evaluation by all State bodies that

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<sup>69</sup> IMF, Making Public Investment More Efficient, Staff Working Paper, 2015

are charged with delivering projects under the Capital Plan. The Code uses a life-cycle approach for all capital and current expenditure, setting out the different evaluation requirements at each stage (i.e. appraisal, detailed planning, implementation and post-implementation review).

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**Recommendation:** Ensure that Ireland's Public Spending Code evolves to keep pace with best practice both nationally and internationally.

**Responsibility:** Department of Public Expenditure and Reform

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### Leveraging Non-Exchequer Investment Instruments

The State has a critically important role to play in encouraging or incentivising private-service providers to improve infrastructure capacity and to deliver more cost-effective, high quality services to business users. There is also a vital private sector dimension to consider as many economic infrastructure areas receive limited or no Exchequer funding – these include energy, telecoms, waste and air and sea ports infrastructure. Policymakers need to ensure that the right policy framework is put in place to stimulate investor confidence in long-term projects (e.g. regulatory and planning certainty), and to ensure the supply chain has the certainty and tools to deliver effectively.

In the past, Ireland has successfully utilised public-private partnership (PPP) approaches to fund infrastructure delivery, and such models will continue to be an important source of funding. While the Infrastructure and Capital Investment Plan announced the development of a new 3<sup>rd</sup> phase of the Government's PPP plan (to include about €500 million of PPP projects in addition to those already in existence), there may be scope to further expand private investment. It is important, however, to ensure that approaches such as PPPs are structured to maximise value for money for the Exchequer in terms of return on investment and strategic infrastructure asset ownership, in both the short term and over the longer term.

Ireland must also ensure it makes use of European funding for infrastructure investment, particularly the European Fund for Strategic Investments (EFSI). The EFSI is an initiative launched jointly by the EIB Group (comprising the European Investment Bank and European Investment Fund) and the European Commission to help overcome the current investment gap in the EU by mobilising private financing for strategic investments. Ireland is already benefitting from EFSI/EIB funding through the Investment Plan for Europe<sup>70</sup> and has received a €70 million 27 year loan from the EIB, supported by the EFSI to help fund the construction for the 14 primary health care centres<sup>71</sup>. There is also potential to receive EFSI funding in areas such as: broadband; transport and energy infrastructure; and support for SMEs/commercial enterprises. It is vital therefore that the private and public sector in Ireland maximises the drawdown of funding which may be available under the EFSI.

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**Recommendation:** Develop and source non-exchequer investment to support the delivery of economic infrastructure. Options include (i) Public-private partnerships; (ii) funding channels such as the European Strategic Investment Fund; and (iii) special purpose vehicles.

**Responsibility:** Department of Public Expenditure and Reform, Various public and private sector bodies

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<sup>70</sup> The Investment Plan for Europe focuses on removing obstacles to investment, providing visibility and technical assistance to investment projects and making smarter use of new and existing financial resources. The EIB estimates that approved projects and SME agreements are expected to trigger total investment of over €100 billion.

<sup>71</sup> European Commission, 14 new primary health care centres to be built across Ireland, supported by the Investment Plan for Europe, Press Release, Brussels, 25 May 2016. See [http://europa.eu/rapid/press-release\\_IP-16-1903\\_en.htm](http://europa.eu/rapid/press-release_IP-16-1903_en.htm)

### Land Transport

As Ireland experiences strong demographic and economic growth, an efficient and integrated national transport system with adequate capacity and levels of service is vital to move goods and people efficiently, safely and in environmentally sustainable ways by land. In the years preceding the crisis significant investment in Ireland's road network was undertaken: over the period 2007-2010, Ireland's motorway network increased from 269km to 900km and has remained at this level since. As a result of the deterioration in Ireland's public finances, the Exchequer funding available for roads expenditure has declined significantly.

While remaining a little below pre-recessionary levels, CSO data shows the numbers of private and commercial vehicles on Irish roads and kilometres travelled continues to grow on an annual basis and targeted, prioritised and cost effective investment is now urgently required at national and local authority level<sup>72</sup> to minimise congestion and associated costs in the short to medium term, and to ensure that Ireland's road infrastructure provides a safe and reliable system for the movement of people and goods.

The land transport network is particularly important in terms of freight traffic to and from Ireland's airports and ports. CSO data shows that in 2015, the quantity of goods transported by road increased by 4.9 per cent to 118.1 million tonnes. The volume of goods handled by Irish ports increased by 6.7 per cent compared to 2014. Improving connectivity and access to the main air and sea ports is critical for enterprise cost competitiveness.

The capital plan provides €6 billion for investment in the roads network in the period to 2022, with €4.4 billion earmarked for the maintenance and strengthening of the existing extensive network throughout the country and €1.6 billion for new projects. Despite this welcome uplift in investment it has been estimated that the planned level of expenditure will not be sufficient to maintain the existing land transport network. It is crucial that this allocation is reviewed as part of the Mid-Term Review of the Capital Plan.

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**Recommendation:** Continue to invest in ongoing maintenance of the motorway and national road network to facilitate access to major urban areas, and to optimise the substantial investment already made while reducing the need for significant remedial work in the future. In the context of the Mid-Term Review of the Capital Plan examine the adequacy of the allocation for road infrastructure (in terms of the balance between expenditure on maintenance and upgrading, and new works).

**Responsibility:** Department of Transport, Tourism, and Sport, Department of Public Expenditure and Reform

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The 2015 Strategic Investment Framework for Land Transport confirms that maintenance and renewal of Ireland's land transport network will be the main priority in the coming years. Accordingly, the bulk of the capital budget for transport is reserved for this purpose. However, a number of bottlenecks in the road network at regional and inter urban levels should be addressed to capture the full benefits of the significant investment in road and other infrastructures already made.

As a general principle, the Council believes that in the first instance planned investment in the road network should be cost-efficient, address safety concerns, and relieve existing bottlenecks and congestion. Infrastructure which supports the productive economy and is informed by enterprise needs should be prioritised. Improving road access between

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<sup>72</sup> The improvement and maintenance of regional and local roads in its area is a statutory function of local authorities in accordance with the provisions of Section 13 of the Roads Act, 1993. Works on such roads are a matter for the relevant local authority to be funded from its own resources supplemented by State road grants. The planning, design and implementation of individual road projects is a matter for Transport Infrastructure Ireland.

and around the main regional urban centres in the near term - in particular those identified by the enterprise agencies - N20 Limerick-Cork upgrade, N21 Limerick-Tralee upgrade, and sections of the N25 Cork-Waterford road and completing the Galway city Outer Bypass to enhance access in and around the city and the hinterland remain priorities.

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**Recommendation:** The four identified priority projects in the Capital Plan should progress without delay (the M7 Nass-Newbridge widening project, the Sallins Bypass, the N59 Moycullen bypass outside Galway on the road to Sligo, and the Grange Castle Business Park works in west Dublin). Likewise, those projects referenced as essential by the Development Agencies should also be prioritised (N20 Limerick-Cork upgrade, N21 Limerick-Tralee upgrade, and sections of the N25 Cork-Waterford road and completing the Galway city Outer Bypass).

**Responsibility:** National Transport Authority

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Given Ireland's dispersed population the need for a private passenger car fleet and a well maintained, efficient and safe road network is clear. CSO data shows the strong prevalence of car usage as the primary mode of transport in Ireland<sup>73</sup>. At the same time, promoting alternative reliable and affordable public travel modes, particularly public transport in urban areas and between major towns and cities and their hinterlands, is essential in terms of reducing congestion, cost savings and meeting our environmental commitments.

High quality public transport, particularly in urban areas, facilitates labour market flexibility, productivity and enhances quality of life. To promote greater use of public transport Ireland needs high quality, frequent, reliable and competitively priced access to, from and within the main urban centres. This should be delivered via competitive or regulated markets. The planned allocation of capital funding for public transport under the Capital Plan is €3.6 billion and the Department of Transport, Tourism, and Sport estimates that the funding allocations for public transport under the Capital Plan will reach "steady state" funding levels by 2020.

With regard to public transport, investment must in the first instance meet existing and emerging demand constraints particularly with regard to enhancing urban mobility in Dublin and other city regions. As set out in this year's *Scorecard*, the relative size of Dublin is an important consideration from a planning and development perspective, with 28 per cent of the total population resident in Dublin.

The publication of the Greater Dublin Area Transport Strategy 2016 – 2035 is a very positive development in terms of transport infrastructure planning and the focus now must be on well planned and executed implementation. The core elements of the Greater Dublin Area Transport Strategy comprise a wide range of actions with regard to demand management measures and specific actions in terms of developing the bus network, light and heavy rail, road, cycling and park and ride. Providing adequate, frequent and competitively priced services, particularly at peak times, to concentrations of employment is key. Completion of LUAS Cross City on schedule, increasing LUAS capacity (trams, platforms), park and ride provision, and designing a Bus Rapid Transport option (Blanchardstown to UCD, Clongriffin to Tallaght) are welcome initiatives underway which are designed to reduce bottlenecks and commuting times. It is vital therefore that design and planning work on vital new projects such as Metro North and the DART to Balbriggan progress on schedule. Furthermore, the South West Regional Action Plan for Jobs 2015-2017 commits both Local Authorities in Cork to engaging with the NTA in order to upgrade public transport links in the city.

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<sup>73</sup> In 2014, 75 per cent of all journeys were by car. CSO data also shows that those living in Dublin were significantly less likely to drive than those in the rest of the country. Journeys by public transport for Dubliners (12.5%) were more than four times greater than in the rest of the country.

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**Recommendation:** Identify key priority actions and timeframes for delivery under the National Transport Authority's Transport Strategy and Implementation Plan for the Greater Dublin Area 2016 – 2035.

**Responsibility:** National Transport Authority

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**Recommendation:** Ensure that the public transport component of the Mid-Term Review of the Capital Plan, and the development of the new National Planning Framework prioritise investment in a manner that is evidence-based and responds to the particular strategic opportunities present for all regions.

**Responsibility:** Department of Transport, Tourism, and Sport

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### Energy

Timely and cost effective delivery of Ireland's electricity and gas infrastructure is key to achieving competitiveness, climate change and energy policy objectives. The Council has consistently advocated that Ireland's energy policy should emphasise the importance of cost competitiveness alongside the other pillars of security of supply and sustainability. The Council therefore strongly welcomes the publication of the Energy White Paper: Ireland's Transition to a Low Carbon Energy Future 2015-2030, which addresses three core objectives– the 'three energy pillars' – of sustainability, security of supply and price competitiveness.

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**Recommendation:** Develop a target led, time bound implementation plan around the priorities identified in the Energy White Paper.

**Responsibility:** Department of Communications, Climate Action and Environment

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It is vital that energy policy appropriately balances competitiveness and environmental objectives. While improving Ireland's environmental sustainability is important, it must be done at least cost. For many sectors, changes in energy costs have a considerable impact on their export competitiveness. For example, energy intensive pharma-chemical products make up half the total goods exported from Ireland making the sector critical from an FDI and external trade perspective. For less energy-intensive industries, particularly SMEs, any increase of energy cost shares may still affect export competitiveness on the margin.

A Commission for Energy Regulation survey of SMEs finds that average expenditure on electricity as a percentage of non-wage costs is 9 per cent<sup>74</sup>. In highly competitive sectors, such as food if profits are not high enough to offset even an incremental increase in energy costs, export competitiveness may suffer as a result.

While a large portion of the energy cost base is outside of the control of policymakers, tackling the controllable cost components and delivering energy infrastructure investment at least cost must be vigorously pursued as part of the new energy policy framework. Effective independent regulation is a fundamental condition to reduce the cost of capital for energy investors and operators, and ensures lower costs for consumers than would otherwise be the case. It is important to ensure that strong independent energy regulation, with adequate resourcing, remains a core feature of Irish energy regulation. Given the significant changes envisaged in the White Paper it is vital that the legal and institutional framework for the electricity and natural gas markets and the regulator's mandate are reviewed to ensure

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<sup>74</sup> Commission for Energy Regulation, SME Electricity Market Survey Results, 2015



that the Commission for Energy Regulation is best placed to support the implementation of energy policy and to deliver a competitive, secure and sustainable energy supply.

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**Recommendation:** Review the legal and institutional framework for the regulation of electricity and natural gas markets including the CER's mandate and resourcing in line with the Government's Energy White Paper.

**Responsibility:** Department of Communications, Climate Action and Environment

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The Infrastructure and Capital Investment plan envisages that commercial semi-state companies will invest close to €6 billion in core infrastructure and power generation, including renewables over the period 2016-2021. This includes a north-south transmission line to increase interconnectivity with Northern Ireland, smart metering and increased grid capacity in several parts of the country. Given Ireland's heavy dependence on imported energy, security and sustainability of supply are core pillars of our energy policy framework.

The energy implications for Ireland of Brexit could be very significant in terms of security of supply (see Chapter 9). As set out in the Government's Brexit contingency plan, it is important that a full assessment be undertaken of the issues that may arise for energy supply under different scenarios envisaged in the pre-negotiation phase. Since 2007 Ireland has benefited from the creation of an all-island energy market and interconnection with the UK. Ensuring the optimal functioning of the integrated all island energy market remains important from a competitiveness perspective. Increasing electricity interconnection to Britain and continental Europe would help diversify the electricity fuel mix.

The Council welcomes the planned development of a second interconnector to supplement the single electricity interconnector between Ireland and Northern Ireland. Delays to the North-South electricity interconnector (which was due to be operational by 2011 but is not now expected before 2019) are estimated to be costing consumers on the island of Ireland approximately €20 million per annum as a result of higher production costs and a reduced ability to share generation capacity across the island. The completion of North-South infrastructure is another immediate priority.

The implications of further investment in additional capacity for energy cost competitiveness against medium term security of supply considerations must be carefully assessed before decisions are made to promote more generation capacity. Gas supplies in particular are of particular strategic importance in terms of Irish electricity generation. However, Ireland only has gas interconnection to the UK and while there are two gas pipelines with two separate entry points into Ireland, both pipelines are connected through a single facility in Moffat, Scotland. In addition, gas storage capacity is limited in Ireland. As detailed by the ESRI, storage constraints pose a security of supply risk and constrain smoothing of the seasonal fluctuation in gas prices. It is therefore critical that a twin pipeline is installed at Moffat. It is also important that the Corrib supply is brought up to capacity.

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**Recommendation:** Assess the issues that may arise for energy supply, security and costs under the different scenarios envisaged in the pre-negotiation phase of Brexit.

**Responsibility:** Department of Communications, Climate Action and Environment

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**Recommendation:** Progress the installation of a twin pipeline at Moffat (i.e. interconnection with the UK).

**Responsibility:** Gas Networks Ireland

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**Recommendation:** Complete the construction of the north-south interconnector to bolster security of supply and reduce energy costs.

**Responsibility:** Eirgrid

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The effective application of advanced technologies to more effectively and efficiently manage complex infrastructure systems, by using embedded sensor technologies to harness and apply real time data also represents an area where Ireland's infrastructure competitiveness might be enhanced. Ireland has distinct advantages as an agile test bed for these technologies. In the area of Smart Grids our island status means that our national electricity grid provides an ideal vehicle of research and deployment.

A Smart Grid is an electricity network that can cost efficiently integrate the behaviour and actions of all users connected to it – generators, consumers and those that do both – in order to ensure an economically efficient, sustainable power system with low losses and high levels of quality and security of supply and safety<sup>75</sup>.

Ireland needs to ensure that adequate regional/local spare network capacity exists to meet additional enterprise demand, especially in the main urban centres. This is particularly important to facilitate large, energy intensive manufacturing or data-centre activity. It is important that energy network investment is targeted to meet future demand in a timely manner and that investment costs are minimised (e.g. new generation capacity is built in the optimal locations and planning delays are reduced). Ireland already has considerable spare electricity and grid capacity in certain locations, with Dublin the only region where electricity demand exceeds generation.

The introduction and roll out of smart meter technology could also facilitate more efficient and less expensive electricity consumption. The Commission for Energy Regulation (CER) is currently developing the National Smart Metering Programme to help Ireland achieve the EU of 80 per cent of residential consumers having electricity smart meters by 2020. In Ireland, a cost benefit analysis is being developed by the CER. The results from this analysis (due in Q2 2017) will be the key determinant in the scale, scope and timing of the roll-out of smart metering.

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**Recommendation:** Complete cost-benefit analysis for Smart Metering and consult with enterprise to determine the optimal scale, scope and timing of the roll-out of smart metering in Ireland.

**Responsibility:** Commission for Energy Regulation

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### Telecommunications

The widespread provision of high speed broadband services is critically important to support regional economic growth and job creation, and in particular for many small and micro businesses located in the regions, and to support home-working. Enhancing Ireland's international and national connectivity is critically important to support the future needs of existing and new companies in ICT, digital media and other data intensive sectors across all regions. Ireland has improved its telecommunications infrastructure and broadband is now an integral resource for enterprise.

National and international connectivity has improved in recent years. Subscriptions to fast broadband (at least 30 Mbps) in Ireland have again seen a significant increase over the last year to 51 per cent of total fixed broadband subscriptions, up from 45 per cent in 2014. Prices for fixed broadband in Ireland, however, are almost double the EU average, when measured as a proportion of income, and remain unchanged since last year.

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<sup>75</sup> SEAI, Smartgrid Roadmap, 2011

The telecommunications sector has invested over €2 billion in the past four years, in modernising networks including significant upgrades to 3G and 4G services. Continued investment by the commercial sector will be required to ensure that Ireland's connectivity continues to improve. Access to high speed reliable telecommunications is still more concentrated and reliable in areas of high population density and its extension to other areas is badly needed. It is estimated that 70 per cent of all premises in Ireland will receive high speed services from the commercial telecommunications market. Approximately 1.3 million premises across Ireland now have access to speeds of at least 30 Mbps. Fibre-to-the-home is currently being rolled out by both SIRO and eir and this is a welcome initiative in the market.

The Council appreciates the significant challenges (e.g. small and dispersed population) in delivering high speed broadband services in Ireland and acknowledges the substantial investment made by the private and public sector to date, which has significantly improved Ireland's broadband offering, particularly in urban centres. The Programme for Partnership Government established a mobile phone and broadband Taskforce to consider immediate measures to address telecommunications deficits in rural Ireland.

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**Recommendation:** Identify specific barriers and recommend actions to improve mobile and broadband access pending the rollout of the National Broadband Plan.

**Responsibility:** Mobile Phone and Broadband Taskforce

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Under the National Broadband Plan (NBP), fibre based broadband services will be available across all parts of the country by 2020. This is being achieved through private investment by commercial telecommunications companies and through a State intervention in areas where commercial investment is not forthcoming. The formal procurement process for the State Intervention commenced in December 2015, and in July 2016 the Government chose the Commercial Stimulus Model (by which the private sector will finance, design, build, own and operate the network, with contractual obligations to the Department) as the optimum ownership model for the network that will be part-funded by the Exchequer under the procurement process. Under the National Broadband Plan, there is a requirement for the successful bidder(s) to rollout 60 per cent of the network by 2019 and 100 per cent by 2020, and that 85 per cent of premises in Ireland have access to high speed services by 2018.

The availability of high speed symmetric services (same upload and download speeds) is becoming increasingly important for enterprise. The Council recommends, therefore, that the network built under the intervention strategy must be future proofed to effectively meet future increases in demand for significantly higher download speeds (in excess of 100 Mbps) and also higher upload speeds from businesses, homeworkers and other residential users. The Council notes that the targets of rolling out a minimum of 30 Mbps broadband to homes and businesses, but that this is a minimum standard, rather than a ceiling<sup>76</sup>. The Council welcomes the commitment in the *Programme for Partnership Government* to deliver the NBP as a priority. It appreciates in particular, the need to comply with EU State Aid rules.

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<sup>76</sup> The NBP's predecessor, begun in 2009, delivered a basic download speed of 1.2 Mbps to 250,000 homes but was obsolete even before its completion. The European Commission have announced a new target of achieving internet connection speeds of 100 megabits per second (Mbps) for all homes, which is significantly faster than the 30 Mbps minimum laid down in the Government's National Broadband Plan (NBP). See European Commission, Connectivity for a Competitive Digital Single Market - Towards a European Gigabit Society, COM(2016) 587 final, September 2016

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**Recommendation:** Award the National Broadband Plan intervention to a contractor(s) and confirm the revised deployment schedule to ensure the timely rollout of the Plan. Ensure that the network is scalable and proofed to meet future demand for significantly higher download speeds (in excess of 100 Mbps) and higher upload speeds.

**Responsibility:** Department of Communications, Climate Action and Environment

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To complement the ongoing delivery of the NBP, the development of a new National Digital Strategy should be progressed. This should take into account domestic and international developments since 2013 including the EU's Digital Single Market agenda and the Government's Data Forum and Ireland's Data Protection Roadmap. The new Strategy is likely to need a whole of Government commitment to deliver. A new strategy should be developed to enable pilot programmes to be rolled out and finessed in 2017/2018 with a view to full rollout by 2020 to coincide with universal high speed broadband availability in 2020.

As well as making the proposed State intervention more cost effective, a new strategy would also help support other Government priorities such as positioning Ireland as a global digital hub, supporting job creation and economic growth in every region in the country, maintaining Ireland's attractiveness as a location for inward investment, supporting SMEs, realising new enterprise opportunities (e.g. test-bed for the Internet of Things and Assisted Living) and delivering better educational and health outcomes for all our citizens.

In addition, the revised digital strategy should encourage local stakeholders such as the Local Enterprise Offices (LEOs), the local authorities and local community groups to work with retail service providers to maximise the use of the services that they can currently provide and to lay the groundwork for a rapid take-up of the high speed broadband services as they are rolled out across the intervention area.

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**Recommendation:** Commence work on the successor to the National Digital Strategy.

**Responsibility:** Government, Department of Communications, Climate Action and Environment

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### Water and wastewater services

The consequences of inadequate planning, low levels of investment in water infrastructure, and inadequate wastewater treatment facilities have been well documented in previous Council reports and elsewhere<sup>77</sup>. Ensuring an adequate revenue stream to maintain water and wastewater services, to upgrade the public water and wastewater systems, and to fulfil our EU commitments is critical to delivering the required investment.

Irish Water has statutory responsibility for all aspects of water services planning, delivery and operation for public water services, including the delivery of water and wastewater infrastructure. The uncertainty regarding the future funding of Irish Water and the challenges this creates in terms of infrastructure planning and development is a major concern.

An Expert Commission has been established to make recommendations to the Oireachtas on funding of domestic public water services in Ireland and improvements in water quality, taking into account, inter alia, the maintenance and investment needs of the public water and waste water system on a short, medium and long-term basis.

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<sup>77</sup> Engineers Ireland estimate there are 45 locations where sewage is being discharged untreated or with preliminary treatment only, 156 wastewater treatment plants are overloaded and below required standards and major and extensive upgrades to the wastewater networks are required to meet EU standards. See Engineers Ireland, Review of Infrastructure in Ireland, 2016

While the funding model for Ireland's water sector is undergoing a review, and domestic charges have been suspended, it remains critical that our water services policy and regulatory framework are designed to ensure the provision of quality water services infrastructure in a sustainable and cost competitive manner. The need for investment remains clear.

In this regard, resolving the uncertainty regarding the funding model for the water and wastewater utility is a priority. Already, the shortfall in revenue to Irish Water arising from the suspension of domestic water charges is estimated at €181million for 2016.

The Council previously outlined the importance of adopting a medium to long term approach to water and wastewater services and infrastructure. It, therefore, welcomes the long-term approach to investment planning which has been set out in Irish Water's Business Plan, published in 2015<sup>78</sup>. Irish Water plans to invest €5.5 billion over the period 2014-2021 to address deficits in water and wastewater treatment capacity and infrastructure investment; to remove lead piping from the public network; reduce leakage and support sustainable industrial and commercial development.

In the short term, it is vital that the current water services constraints in Dublin are addressed urgently to ensure that the region has sufficient supply to meet future demand, and to provide the 15 per cent headroom which is the norm in most European capital cities. In addition, to support regional development, sufficient capacity to support expansion plans and new developments, especially in the large regional urban centres, must be supported. In particular, providing the required water supply capacity and requisite drinking water quality in enterprise agency strategic sites and business parks and strategic development zones should be prioritised.

There needs to be a continued strong focus on reducing leakage nationally. Leakage from the water network in Ireland is estimated to total 47 per cent of all water produced in Ireland, twice the level of England and Wales. Leakage is over 30 per cent in the Greater Dublin Area where supplies are critical. Given the capacity deficits in many centres and the limited funds available for capital investment in water services, prioritising investment to reduce leakage will increase the volume of water available without creating further demand for capital investment in new water treatment capacity.

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**Recommendation:** Develop a clear plan that provides certainty with regard to the future funding of public water and wastewater services in Ireland. It must deliver an adequate funding stream, facilitate investment, meet EU objectives in terms of the user pays principle, and must avoid cross subsidisation.

**Responsibility:** Government, Department of Housing, Planning, Community and Local Government

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From an enterprise competitiveness perspective, the key issue is to ensure that businesses have access to competitively priced water and waste water services and that there is certainty and transparency regarding cost of provision and price. In line with the EU Water Framework Directive and the Water Services (No.2) Act 2013 there should be no cross-subsidisation of domestic water charges by nondomestic users. A new tariff framework for non-domestic users is to be developed, by the economic regulator (the Commission for Energy Regulation). The delay in this project is increasing the uncertainty for business.

The new charge(s) must converge on the economic cost of efficient provision. Of particular importance for enterprise is how existing standing arrangements and legal agreements between non-domestic water users and local authorities

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<sup>78</sup> Ervia, Irish Water Business Plan: Transforming Water Services in Ireland to 2021, October 2015

are to be honoured under the new structures for water services provision. The role of the regulator is paramount in delivering efficiencies and effective water services investment.

It is important that Irish Water's operating, maintenance, and capital costs are in line with international best practice. The targets set by the CER for Irish Water to improve efficiencies and performance in the future should be informed by the improvements achieved in other jurisdictions at comparable stages of development to deliver competitively priced world class water services and sufficient spare capacity in the longer term. In this regard, it is important that the transformation process to improve the operational efficiency of Irish Water - including €1.1 billion in efficiencies to be achieved over the period to 2021 - is not impacted by current delays.

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**Recommendation:** Publish and keep under review key metrics against which Irish Water's performance will be monitored.

Introduce a Customer Handbook for the non-domestic sector. Ensure that the utility has in place a clear method to effectively communicate with enterprise, and to deliver the service required.

**Responsibility:** Commission for Energy Regulation

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## Chapter 4: Improving Cost Competitiveness

### Why Costs Matter for Competitiveness

International cost competitiveness makes Ireland a more attractive location in which foreign investors can base and develop their operations, and allows Irish firms to compete more effectively in foreign and domestically traded markets. As a small open economy, dependent on exports and foreign investment as major drivers of growth, any deterioration in our cost competitiveness will have a major negative impact upon economic growth, employment and our standard of living. More broadly, a competitive cost base can help to create a virtuous circle between inflation, wage expectations and productivity.

### Current Context

Consumer price inflation - as measured by the Harmonised Index of Consumer Prices (HICP) – was flat in 2015. Indeed, low and even negative rates of inflation are increasingly becoming a feature of developed economies, including Ireland, and this poses challenges. From an Irish perspective, the decline in the price of oil-related consumer products last year, arising from the fall in the wholesale price of oil, offset price increases in other areas, notably for services. Core inflation (i.e. excluding energy and unprocessed food), which gives a better picture of the underlying developments in the economy, averaged 1.2 per cent last year. Despite low levels of inflation, Ireland remains a relatively high cost location and, therefore, addressing our cost competitiveness must remain a key economic priority for enterprise and the Government.

The UK's Brexit decision (see Chapter 9) brings into sharp focus the need for Ireland to maintain and improve our cost competitiveness: the depreciation of Sterling against the euro poses particular challenges on Irish exporters selling into the UK. Only a renewed focus on competitiveness will help to insulate us from external shocks and factors beyond our control.

As we will see, there have been a number of key developments across the areas of interest to the Council – from the development of the Action Plan for Housing and Homelessness, to the enactment of the Legal Services Bill, to the rollout of a range of measures to enhance access to finance (e.g. establishment of the Strategic Banking Corporation of Ireland, creation of the Ireland Strategic Investment Fund, expansion of Microfinance Ireland<sup>79</sup>, etc.), many of which are designed to enhance cost competitiveness<sup>80</sup>.

### How Ireland Performs

The Council published the Cost of Doing Business 2016 report earlier this year. The key findings from *Costs* report, which focuses on areas where Irish enterprise costs are out of line in those in key competitor countries and concentrates on costs that are largely domestically determined, are summarised below.

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79 For example businesses which have been approved a loan by Microfinance Ireland (MFI) can receive mentoring assistance from their LEO. Micro-enterprises can apply for loans of between €2,000 and €25,000 directly to MFI, or indirectly through their LEO. From 1<sup>st</sup> July, businesses applying directly to MFI can avail of a standard rate of 7.8 per cent APR, down from 8.8 per cent. In addition, businesses applying via their LEO can borrow at an even lower rate of 6.8 per cent APR, a highly competitive interest rate for those small businesses who are currently finding it difficult to access finance from traditional sources. The full allocation of funding to MFI as committed to in the Microenterprise Loan Fund Act 2012

80 Substantial work has been undertaken over recent years to enhance the availability of funding for growth for Irish companies. A useful summary of the range of initiatives is available on page 64 of the Action Plan for Jobs 2016. See Department of Jobs, Enterprise and Innovation, Action Plan for Jobs 2016, January 2016

- The cost base for enterprise has improved across a range of metrics since 2009 (e.g. the cost of starting a business, communications costs and average income taxes).
- Ireland, however, remains a relatively high cost location and already the return to growth has resulted in a series of upward cost pressures in some areas of the economy.
- The Council is especially concerned about the rise in both commercial and residential property costs - following several years of significant cost reductions, the availability and cost of property is again a significant threat to sustained cost competitiveness. In particular the dramatic increase in residential rents (back to, and in some locations surpassing, pre-recession levels) is a major cause for concern with potentially significant adverse consequences for the entire economy. Rising rents and increasing house prices will inevitably impact upon wage demands, increase the cost of living and will ultimately damage competitiveness. Likewise, the rapid increase in commercial rents – especially for retail property is a concern.
- The *Costs* report also highlights the high costs associated with a range of business services including legal services and commercial insurance. Relatively expensive legal service costs allied to a rapid escalation in commercial insurance premiums impact upon virtually all enterprises in Ireland. The upward trend across a number of other business services also serves as a warning signal that constraints and cost pressures are emerging.
- While the supply of credit has undoubtedly improved in recent years, Irish firms face higher interest rates and greater volatility in those rates than their competitors abroad. While most firms are understandably primarily concerned about accessing credit rather than the cost of that credit, the interest rate differential between Ireland and the euro area places Irish based enterprises at a distinct disadvantage.

While the *Costs* report covers a range of other cost inputs to enterprise – including energy costs for example - the remainder of this chapter concentrates on these three areas of residential property, business services and cost of finance, in line with the Council's mantra of focusing on those areas over which the State has some influence<sup>81</sup>.

## Policy Challenges and Recommendations

### Property: Residential Property

Housing is an essential part of any society, but also one that has been the source of economic vulnerabilities and crises. The primary challenge, at present, is to deliver housing supply in appropriate locations, sufficient to meet demand at a price level that is affordable, accessible and sustainable. The affordability of housing is a key component of competitiveness. It impacts upon the attractiveness of Ireland as a location for investment and directly impacts on enterprise costs through wage effects, and indirectly determines the price of Irish goods and services. The cost of housing influences labour mobility and contributes to an economy's ability to adjust to adverse shocks. In short, a well-functioning housing and construction sector is critical to the overall health of society and the economy. The current escalation in residential property costs represents perhaps the greatest threat to Ireland's competitiveness.

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<sup>81</sup> The Council has previously addressed the issue of energy costs in the Competitiveness Challenge 2015 and also in a recent Competitiveness Bulletin. See NCC, Electricity Costs and Competitiveness, Competitiveness Bulletin 15-1, June 2015



The Council has previously set out the importance having a sufficient supply of affordable housing to support competitiveness, and has called for an urgent increase in the supply of housing to counteract rapid increases in residential rents and property prices.

A range of policy initiatives have already been implemented in this space, including reforms in the rental sector increasing the rights and protections of tenants<sup>82</sup>; new planning guidelines on design standards for apartments; and a new social housing policy<sup>83</sup>. An Action Plan for Housing and Homelessness was published in July 2016<sup>84</sup>. The aim of this Action Plan is to ramp up delivery of housing from current supply levels, across all tenures to help individuals and families meet their housing needs. The Council welcomes this Action Plan, and in particular the commitment to establish a high-level Housing Delivery Office, which is being created within the Department of Housing, Planning, Community and Local Government to support all stakeholders involved in the delivery of housing projects. It further welcomes the commitment for significantly enhanced capital expenditure to boost housing supply, both in terms of substantially increasing social housing investment and targeted infrastructure to unlock strategic land-banks and accelerate the delivery of new homes onto the market. The Action Plan sets out how, in the context of the new National Planning Framework (see Chapter 1), strategic opportunities for urban renewal and regeneration will be identified for coordinated action across relevant public sector bodies.

As with any plan or strategy, the success of the Action Plan for Housing and Homelessness will be determined by the level of implementation achieved. The proposed focus of the Housing Delivery Office on "driving delivery of key elements of the ambitious private and social housing targets in this Action Plan" is, therefore, essential. Likewise, the establishment of a Housing Procurement Unit within the Housing Agency to provide a procurement centre of excellence and advice in support of local authorities and Approved Housing Bodies in the accelerated delivery of their social housing programmes is welcome.

The role played by NAMA is also important in respect of delivery – so many of the interventions in the Housing area focused on facilitating and encouraging housing supply by external parties. The commitment in the Action Plan that NAMA will deliver 20,000 additional units by 2020 is noteworthy, as it represents an action fully within the remit of the State to deliver upon.

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**Recommendation:** Devise a clear implementation plan for *Rebuilding Ireland – Action Plan for Housing and Homelessness* with specific timelines and assigned responsibility for specific actions. Drive implementation through regular reporting and cross-agency collaboration. Establish and resource the Housing Delivery Office and the Housing Agency's dedicated Procurement Unit as a matter of urgency.

**Responsibility:** Department of Housing, Planning, Community and Local Government

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As mentioned, significant concerns persist in relation to the cost of development and the cost of construction. A variety of input costs (e.g. labour, materials, levies and taxes etc.) combine to determine the final cost of construction. To incentivise the construction of new residential property, selling prices need to exceed development costs. From an affordability and competitiveness perspective, it is not necessarily desirable to increase the selling cost of residential property<sup>85</sup>; we must, therefore, address the cost side of the equation to increase the supply of housing.

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<sup>82</sup> See Residential Tenancies (Amendment) Act 2015

<sup>83</sup> Department of the Environment, Community and Local Government, Social Housing Strategy 2020, 2014

<sup>84</sup> Department of Housing, Planning, Community and Local Government, *Rebuilding Ireland: An Action Plan for Housing and Homelessness*, July 2016

<sup>85</sup> Further increases in house prices relative to incomes will not aid affordability; the provision of additional subsidies to aid affordability risks stimulating demand.

Policy interventions can be designed to address supply across a number of fronts. Such interventions might include policies to encourage vacant dwellings to be brought on to the market; social housing policies; and policies to incentivise the expansion of the private rental market. Ultimately, however, additional construction is required. At present, quality detailed and timely data on the cost of construction is limited. However, much of the debate around the barriers to increasing the supply of housing relates to the availability and affordability of development sites. While the evidence suggests that there is sufficient zoned land available we'll go with in the Greater Dublin Area to meet current and future demand, the process of making this land available to the market and ensuring it is developed has taken time (i.e. as a result of the economic crash and the financial impairment of the owners of such land banks). However, recent loan sales and the emergence of new entrants in the housing supply sector have begun to improve the land supply process; a number of actions under the Action Plan for Housing and Homelessness will seek to make further progress in this regard.

Specifically, the Action Plan for Housing and Homelessness commits the Department of Housing, Planning, Community and Local Government to work with local authorities to select and progress three key sites in local authority ownership for master-planning and delivery of at least 3,000 new homes between 2017 and 2021 in Dublin and other key regional cities. In addition, an early commitment in the Action Plan is to identify and prioritise 15-20 strategically located sites in urban areas which have the proven capacity to deliver a significant scaling up of new homes, in conjunction with local authorities, landowners and builders and other stakeholders. Furthermore, a programme will be put in place under a State Lands Management Group to identify and release further sites from the ownership of other public bodies for master-planning and making them available to a variety of scales of developers with the potential to deliver at least 500 homes initially in 2017 and building up incrementally after that to a potential capacity for provision of up to 1,000 homes annually by 2021.

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**Recommendation:** Establish the State Lands Management Group with the clear objective of improving the supply of affordable development land. Drive proactive engagement with all relevant interests on the large-scale strategic sites to accelerate the delivery of new homes in our urban areas.

**Responsibility:** Department of Housing, Planning, Community and Local Government

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Ultimately additional construction is required to ensure that the housing market does not undermine our competitiveness. Innovative approaches to construction offer a potentially significant tool to reduce costs and boost productivity.

Several initiatives have already been put in place to reduce housing delivery costs. Dublin local authorities have reduced development contributions by 24 per cent; the Department of Housing, Planning, Community and Local Government has introduced statutorily backed harmonised apartment standards that remove hidden costs in apartment construction of around €20,000; Part V social housing provision has been streamlined and re-focused; and recent changes enable up-front purchase of such units further aiding cash-flow for housing projects.

Increasing housing construction and precursor activities such as planning application and pre-application consultation activity (up 24 per cent) signal that the economic viability of new home development is recovering, primarily in relation to for suburban build-for-sale projects rather than apartment developments and the build-to-rent model. It is essential however, that as recovery takes hold, there is a relentless focus on cost competitiveness for all aspects of the input costs to housing provision, including land, building material and construction costs, labour, finance and taxes and charges.

All of the cost inputs above will vary between housing projects. To champion innovation and provide exemplars for efficient delivery, the Action Plan contains a commitment that a competition will be held to champion best practice,

efficient and cost effective design to enable the delivery of high quality homes in sustainable communities at an affordable level.

Designed to demonstrate high quality, affordable, efficient design and construction, this initiative is aimed at challenging designers and housing providers to come up with an innovative and high quality benchmark design and delivery approach that is both fully building standard and regulation compliant. The design must also be capable of delivering new homes for less than €200,000 ("all in" delivery cost net of site cost), on foot of which a suitable State site will be provided for delivery of the homes within 18 months. This competition will be advanced by Q4 2016. The competition (and the ex-post analysis of its exemplar projects) is expected to provide an effective basis for analysis of cost drivers and will be used for comparison in a wider industry context.

There may be scope to link the release of sites under the auspices of the State Lands Management Group with this competition to further encourage increased supply.

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**Recommendation:** Launch the competition to develop innovative systems for the delivery of affordable high quality residential development. Analyse the cost savings and disseminate the learnings from the competition to housing stakeholders.

**Responsibility:** Department of Housing, Planning, Community and Local Government

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In order to facilitate large-scale construction activity, developers and investors will require access to capital. The development of equity finance to support development is particularly important in helping deliver the ambition of the Action Plan for Housing and Homelessness. Concerns persist about the ability of Irish developers to source the required 30-35 per cent of funding through equity to proceed with property developments. Addressing this deficit will require a combination of upskilling and attracting a new breed of entrants to the Irish residential construction sector.

Regarding the demand for equity financing, a recent Department of Finance study noted that "a number of developers hard-hit by the crisis do not have sufficient levels of their own risk capital to invest and must access third party risk capital to undertake development. However, some developers are slow to accept the (appropriately priced) higher cost of equity funding, while other developers lack the necessary experience and information to access equity funding"<sup>86</sup>. It is important that this situation is monitored and where necessary, that actions are developed to support a transition from the current underdeveloped equity finance market to a scale that is appropriate for Ireland's development needs.

From a competitiveness perspective, the affordability of housing and rent levels impact upon the attractiveness of Ireland as a location for investment and indirectly impacts on enterprise costs. Rental costs can affect decisions around labour mobility and the attractiveness of entering employment. The cost of rent is also an important determinant of the level of consumer price inflation. Housing and rental costs also affect labour mobility within an economy. Irish rents are now above their previous pre-recession peak.

Increases in rent supplement and Housing Assistance Payment (HAP) limits - taking account of geographic variations in market rents – have recently been announced to deal with the rapid increase in residential rents. While the Council recognise the important social policy considerations underpinning the decision, such interventions do not represent a sustainable solution to the current housing market challenges. Demand side measures generally favour one part of the market over another (e.g. purchasers or renters or vice versa) but don't solve the affordability problem.

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<sup>86</sup> Department of Finance, Construction 2020: Report on Access to Finance for Construction and Development, March 2015

Research from the Department of Social Protection indicates that historically rent supplement has contributed to rental price inflation with rent limits at times in excess of what market averages would dictate<sup>87</sup>. Continuously increasing limits is likely to yield only a very marginal increase in available supply for rent supplement recipients, if at all, with the only certainty being that raising limits will increase costs disproportionately for the Exchequer with little or no additional housing supply coming on stream. Significantly increasing the limits may lead to even more sustained rental market inflation which would impact not only Rent Supplement recipients, but would also negatively affect people currently not in receipt of benefits (i.e. lower-income workers). There is also a risk increases in rental prices will result in heightened wage demands.

In 2015 a range of reforms to the regulation of the rental market were announced – primarily designed to protect tenants and provide rent certainty<sup>88</sup>. The Action Plan outlines additional measures, including the development of an Affordable Rental Programme. This Programme is intended to provide long-term affordable residential accommodation for low to moderate income key-worker households in urban areas of high demand.

Given the complexity of the rental market, it is important that interventions are not pursued in piecemeal fashion. Only an overarching and complementary series of interventions will deliver the desired outcome. In this regard the proposed development of a comprehensive strategy for the rental sector is particularly welcome. The Strategy will aim to “increase supply and support the development of a stable, strong and viable rental sector offering true choice for households, investment opportunities for providers and reflect rights and responsibilities of tenants and landlords”.

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**Recommendation:** Develop and publish a strategy for the rental sector by the end of 2016.

**Responsibility:** Department of Housing, Planning, Community and Local Government, Residential Tenancies Board<sup>89</sup>

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### Property: Commercial Property

During the downturn in the commercial property market, there was limited office construction activity in the Dublin market between 2011 and 2013. As a result, no new office space has been delivered to the Dublin market in the five years to 2015<sup>90</sup>. The dearth of suitable space makes Dublin (and other cities in similar situations) less attractive, and weakens our ability to attract FDI: the ESRI have estimated that new and existing FDI companies account for up to 70 per cent of the take-up of office space in Dublin.

With strong demand and limited new supply, vacancy rates in the Dublin have declined sharply in the post-crisis period. For the first time in 15 years, the Dublin office market vacancy rate fell to single figures during 2015 according to the Central Bank. Vacancy rates were even lower in the city centre. These tight market conditions are resulting in increasing rents for many companies. While these issues are most prevalent in Dublin, concerns also persist about a number of other cities, notably Galway.

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<sup>87</sup> Department of Social Protection, Maximum Rent Limit Analysis and Findings Report, February 2015

<sup>88</sup> The Bill provides for a series of major reforms to the private rental sector in Ireland to provide rent certainty and safeguards for both tenants and landlords. One of the main purposes of the legislation is to provide a new deal for tenants which provides for rent certainty, measures will include increasing the rent review period from one to two years, increased notice periods for rent reviews and much greater protections for tenants. The increase in rent review periods will mean that anybody who has faced a rent increase in 2015 will now not have a rent review until 2017. For more detail, see the Residential Tenancies (Amendment) Act 2015

<sup>89</sup> The Residential Tenancies Board's (PRTB) main functions are to maintain a register of private residential tenancies and tenancies of approved housing bodies; provide a dispute resolution service for tenants and landlords (including approved housing bodies) and carry out research into the private rented sector. It also provides policy advice to the Government on the private rented sector.

<sup>90</sup> Duffy, D. and Dwyer, H., FDI and the Availability of Dublin Office Space, ESRI, 2015

The evidence suggests that a sufficient pipeline of commercial stock is now available or due to come on stream to meet demand over the next two years or so, and this will help to ease current pressures. Over the longer term (as with the residential property sector), it is important that sufficient finance (including equity finance) is available to support development activity. Banks, other lenders, and developers need to evolve new funding models that allow for the sharing of risk and which support development. This would complement ongoing development activity in the commercial sector, which at present is primarily the preserve of a small number of Real Estate Investment Trusts (REITs).

There may also be issues relating to leases which are impacting development activity. Whilst landlords prefer longer lease terms, tenants (particularly smaller and/or start up tenants) prefer more flexible leases that accommodate their changing needs. In a tight rental market, tenants have little room for manoeuvre in this regard. There may be merit in investigating alternate approaches to leasing applied in other jurisdictions that provide greater flexibility to potential tenants, but which still provide the certainty required by developers and landlords to obtain funding.

The availability of information and data is a powerful tool in encouraging efficient markets. In this regard, the NCC welcomes the announcement that NAMA and the Central Bank are to co-fund the development of a commercial property statistical system to provide a comprehensive database of commercial sales and lease transactions. It will incorporate the existing commercial lease register, currently produced by the Property Services Regulatory Authority. The initiative will be developed and maintained by the Central Statistics Office (CSO). The Register is not due to become operational until 2018.

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**Recommendation:** Expedite the development of a commercial property price register encompassing data on commercial sales and leases.

**Responsibility:** Central Statistics Office, NAMA, Central Bank

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### Vacant Site Levy

In 2015, the Department of the Environment, Community and Local Government announced the introduction of a Vacant Site Levy. The Levy, which is due to be introduced in 2018, will impose a charge for unused land to combat land hoarding. The proposed annual charge (3 per cent of the market price of the land) is designed to incentivise landowners and developers to utilise land for development in urban centres with a population greater than 3,000.

A register of vacant sites will be drawn up in each local authority and will include sites that do not have a private dwelling and that have been vacant for the previous 12 months. The Council welcomes the introduction of the Levy and the adjoining commitment that the money raised from the levy is to be ring-fenced and used to support housing or improvements in the vicinity of the site. In addition, the drawing up of the Vacant Site Register is an integral part of the City/County Development Plan. This will entail a more proactive approach by local authority planning departments working to secure housing off the key sites they identify in the planning process - including property in the ownership of the State, state agencies, semi-state bodies or local authorities, which are covered by the provisions of the legislation.

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**Recommendation:** Introduce the Vacant Site Levy as planned. Prior to its introduction, review the proposed exemptions to ensure that the Levy is sufficiently broad in scope.

**Responsibility:** Department of Housing, Planning, Community and Local Government

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### Business Services

#### Legal Services

As noted in the introduction, Ireland is currently experiencing a low inflation environment. However, the CPI since 2014 has witnessed strong growth in its business services component.

Legal services are an important input to all sectors of the economy and their cost has a bearing on Ireland's overall competitiveness. Throughout the recession, and relative to most other professions, prices for legal services did not adjust downwards to the degree that might have been expected given economic circumstances. While prices dipped for a brief period in 2013, in Q3 2015 legal service prices were 5.8 per cent higher than 2010 levels.

At present, data on legal service costs in Ireland is limited. The main data source is the CSO's Services Producer Price Index which is published on a quarterly basis. However, this data only captures information on solicitor fees and is based on a small number of respondents to the CSO survey. Renewed efforts are required to expand the sample – ideally to capture data on barrister fees, and to provide more granular costs data on various types of legal services.

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**Recommendation:** Continue to develop a more comprehensive and representative data set on legal service prices.

**Responsibility:** Central Statistics Office, Legal Profession

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The regulatory model for legal professions was overhauled with the enactment of the Legal Services Regulation Act in December 2015. The new regulatory framework allows for the development of competition and it establishes the oversight of legal services professions by an external and independent body, together with a system for public complaints in respect of all legal practitioners. The framework should, therefore, contribute to reducing high legal services costs. The Act provides for:

- The establishment of a new independent Legal Services Regulatory Authority (LSRA), with responsibility for oversight of solicitors and barristers.
- The establishment of an independent complaints system.
- A reformed, more transparent legal costs regime with rules in relation to charging practices by legal practitioners and the information which they must provide to their clients.
- An Office of the Legal Costs Adjudicator to replace the Taxing-Master to deal with legal costs disputes.
- A framework for Alternative Business Models such as Legal Partnerships and Multi-Disciplinary Practices.

The success of the Act will ultimately depend on the independence and resourcing of the Legal Services Regulatory Authority. A reduction in costs will only be achieved if the competition-enhancing and cost-reducing provisions of the planned regulatory framework are stewarded fully into being as a result of the provisions already set out in the Act (through for example, being incorporated in regulations to be issued by the Legal Services Regulatory Authority). In this regard, the specific provisions that have been made for the conduct of periodic reviews of the operation of the Legal Services Regulation Act are welcome. These periodic reviews of the Act will occur in addition to the normal annual strategic and business planning obligations of the new authority. The Competition and Consumer Protection Commission will be a part of this new exercise and has a nominee on the Authority itself.

**Recommendation:** Incorporate the competition-enhancing and cost-reducing provisions of the Legal Services Act rapidly into the regulations to be issued by the independent Legal Services Regulatory Authority. Ensure that the LSRA is adequately resourced to undertake the research necessary to fulfil its mandate.

**Responsibility:** Department of Justice and Equality

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The Act represents just one stage in a planned series of reforms to modernise the provision of legal services. For example, the Act provides for the development of a framework for new legal business models. These new business structures will include public consultation and the early introduction of "Legal Partnerships" between barristers and solicitors or between barristers themselves. Provision is also made for the introduction of "Limited Liability Partnerships". Lawyers will now, as a matter of law, be able to avail of the new legal business models and to operate them freely. The more traditional forms of legal practice will, of course, remain available to practitioners but now as a matter of greater choice. A pathway is also provided under the 2015 Act for the introduction, on foot of formal research and public consultations, of "Multi-Disciplinary Practices" whereby services can be provided at more competitive cost by legal and non-legal service providers together.

The Irish two-tier legal structure of junior and senior counsel allows for higher fees to be charged but does not offer a definitive guide as to the quality of the barrister in question. The process for Senior Counsel appointments should be reformed so that the title becomes a useful quality signal facilitating competition in legal services. Consideration should be given to creating a single tier counsel system; the removal of the distinction would promote meritocracy and would lessen the requirement for clients to engage senior counsels where the complexity does not necessarily warrant a senior<sup>91</sup>. It is noted that the new Act provides for the nomination of persons to become Senior Counsel and also extends access to the Senior Counsel title to solicitors.

Previous studies have found that the cost of conveyancing in Ireland is significantly higher than other countries with similar legal systems. The development of a specialist conveyancing profession with appropriate regulations and standards would enhance competition. Again, it is noted that the investigation of the possibility of creating a specific conveyancer profession is one of the tasks assigned to the Legal Services Regulatory Authority under the 2015 Act.

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**Recommendation:** Continue to modernise the legal service profession. The establishment of a specialist conveyancing profession and the creation of a single tier counsel system should be considered in this regard.

**Responsibility:** Department of Justice and Equality, Legal Services Regulatory Authority

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The high cost of legal services in Ireland is not entirely a result of regulatory factors and so regulatory reform is not the sole response required if costs are to be reduced. Reform of court procedures offers potentially significant cost savings. Previously, the Legal Cost Working Group has recommended that court rules should include a specific order facilitating supervision by the court of the pace of litigation; this should contain measures to penalise unnecessary delays.

Elsewhere, the OCED found that differences in trial length (which in turn impact upon legal costs) appear to be more a function of the structure of spending, as well as the structure and governance of courts, rather than simply the amount of resources devoted to justice<sup>92</sup>. This suggests that significant efficiencies and saving could be achieved through:

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<sup>91</sup> The Legal Services Act contains a provision meaning that the granting of patents of precedence (i.e. conferring the status of Senior Counsel) is no longer solely the preserve of barristers; this is a welcome step.

<sup>92</sup> OECD, Judicial Performance and its Determinants: A Cross Country Perspective – A Going for Growth Report, OECD Economic Papers No. 05, June 2013

- The application of technological solutions (i.e. greater computerisation, use of electronic forms, websites and electronic registers);
- More active management of cases by courts and other governance reforms (e.g. delegation of broader managerial responsibilities to judges covering supervision of non-judge staff and administration of budgets); and
- The systematic production of statistics at court level.

In this regard, two new statutory instruments which came into effect on 1<sup>st</sup> October 2016 and which aim to drive court efficiencies – both at pre-trial stage and during hearings – are welcome<sup>93</sup>. These instruments introduce changes to a range of areas, including case management, pre-trial conferences, certification of readiness for trial, witness statements, expert evidence, modular trials, the use of assessors, and time management at trial. The impact of these new rules on both court efficiency and on costs needs to be monitored to ensure that their objectives are fulfilled.

Following the introduction of an ICT case management system in 2015, data on incoming and resolved cases for first instance courts are now available, enabling the monitoring of how courts keep up with the current workload. Clearance rates were the lowest in the EU in 2014, with courts resolving less than 60 per cent of the litigious civil and commercial cases received. However, this is partly because the current system takes into account non-active cases, which do not add to the workload of the courts.

The new ICT system measures average length of court cases and it is essential to extend it to higher instance courts. In addition, the monitoring and evaluation of court activities as well as quality standards (e.g. time frames and backlog management) are lacking and could be improved (see forthcoming 2016 EU Justice Scoreboard). ICT tools and quality standards that comprehensively cover the whole justice system are essential for the good functioning of courts, as they contribute to a timely handling of cases, contributing to an attractive business environment.

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**Recommendation:** Monitor the impact of recent changes to the Rules of the Superior Courts which are intended to drive court efficiencies. Ensure that the application of the new rules has a positive impact on court efficiency without adverse consequences on costs. Provide the necessary resources to the judiciary to enable them to perform any additional administrative functions arising from application of the new rules.

**Responsibility:** Department of Justice and Equality, Courts Service

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**Recommendation:** Extend the rollout of ICT to courts of higher instance.

Review the outstanding procedural reforms recommended by the Legal Cost Working Group and implement those which remain relevant and feasible, making reference to the findings of the OECD. Consideration should also be given to the role that models such as alternate dispute resolution can play in reducing costs.

**Responsibility:** Department of Justice and Equality, Courts Service

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<sup>93</sup> See Rules of the Superior Courts (Conduct of Trials) 2016 (SI 254 of 2016) and the Rules of the Superior Courts (Chancery and Non-Jury actions and Other Designated Proceedings: Pre-Trial Procedures) 2016 (SI 255 of 2016)



### Insurance

An adequately-reserved, cost-competitive insurance sector is a vital component of economic activity and financial stability. Insurance costs are relevant to businesses of all sizes and in all sectors of the economy. While insurance costs represent a minor component of enterprise operating costs, premium increases can have an impact on costs. Rapid inflation has been recorded for a range of insurance products over recent months<sup>94</sup>. Inflation in the motor insurance market has been particularly pronounced – prices increased by more than one third in the year to May 2016. As set out in last year's Challenge Report, there is a need to focus on the insurance sector from a cost competitiveness perspective and to comprehensively benchmark commercial non-life insurance costs and the drivers of costs in Ireland with costs in our key competitors.

In this regard, the Council welcomes the Department of Finance's ongoing Review of Policy in the Insurance Sector in consultation with the Central Bank, various Government Departments and Agencies and other relevant stakeholders. The objective of the Review is to recommend measures to improve the functioning and regulation of the insurance sector and will include an examination of the factors contributing to the cost of insurance. Four sub-groups have been established to investigate specific elements of the insurance sector (i.e. understanding the motor insurance sector; improving data availability; examining the factors driving the cost of claims; and other public policy issues). The Review is expected to be completed by the end of the year, and an action plan to drive implementation of the priority actions is due to be published in Q4 2016.

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**Recommendation:** Publish the findings of the Review of Policy in the Insurance Sector. Devise a clear implementation plan for addressing issues regarding data availability and the factors driving up insurance costs. The plan should have specific timelines, reporting mechanisms and assigned responsibility.

**Responsibility:** Department of Finance

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### Finance for Growth

Finance is the lifeblood of every business, and access to competitively priced sources of finance is essential to facilitate enterprises to establish and expand their operations, improve productivity and ultimately survive and scale. Limited or costly credit damages the environment for entrepreneurship, scaling and investment. While the supply and demand for credit has improved significantly since the height of the crisis, access to bank credit and associated costs continues to act as a drag on the enterprise sector, inhibiting investment and growth, particularly amongst start-ups and SMEs seeking to scale and expand.

While in previous years, the Council's primary focus in the finance space has been firstly to improve access to traditional bank finance, then to address the cost of bank finance, the availability of non-bank sources of finance is now also a priority. As demonstrated below, access has improved, and the remaining cost differential between Ireland and other EU countries in relation to credit primarily reflects different risk profiles.

As is the case for many other goods and services, increasing competition and choice in the market is one of the main methods to reduce costs – in this case, the NCC are taking a broad definition competition, encompassing a diverse set of credit sources, ranging from traditional bank finance, to equity and venture capital, to alternate sources of finance

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<sup>94</sup> The IMF note that the insurance in Ireland is well developed, diverse with a large international business. In terms of its impact on the economy, they note that insurance penetration in Ireland is almost three times the EU average and four times more premium per capita is spent than the EU average. See IMF, Insurance Sector and Update on the Assessment of Observance of the Insurance Core Principals, September 2016

such as peer-to-peer lending. The various Government initiatives already in place in the space are vital elements in providing choice and alternatives to potential borrowers.

### Access to Finance

Finance conditions for SMEs are improving and this is seen as a reflection of the intensive efforts by Government over the past number of years. The Central Bank's latest SME Market report shows that rejection rates<sup>95</sup> and the number of small and medium-sized businesses with bad debts<sup>96</sup> continue to fall. Nevertheless, the financing environment remains challenging and SMEs are still heavily reliant on bank loans with limited uptake of non-bank financing sources.

The CSO's Access to Finance 2014 survey shows that bank finance was the most popular type of finance sought by SMEs. Relatively few SMEs sought alternative sources of growth - for example only 4.7 per cent of medium sized enterprises looked for equity finance, compared to 39.8 per cent of similar sized enterprises who sought bank finance. It is clear SMEs still prefer bank loans to non-bank financing and alternative sources of finance. In overall terms Ireland performs poorly in relation to equity finance with private equity investment decreasing markedly in Ireland between 2007 and 2014. At 0.16 per cent of GDP, equity finance is below the best EU performers and the UK<sup>97</sup>. Similarly, venture capital investment as a percentage of GDP in Ireland is marginally below the OECD average.

The commitment in the Government's Summer Economic Statement to deliver an additional €1 billion per year in new sources of finance through a range of measures is welcome. The proposed measures include:

- New forms of equity;
- Mid-sized investment rounds;
- Development finance for manufacturing and international services;
- Export and trade finance; and
- Peer-to-peer lending.

However, further efforts are required to develop, and increase the uptake of alternative sources of finance.

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**Recommendation:** Continue to monitor the landscape for enterprise finance so that viable businesses are not constrained by an inability to access finance. Where gaps are identified, develop proposals to provide alternative sources of finance, with a particular focus on SMEs and on equity finance.

**Responsibility:** SME State Bodies Group, Department of Finance, Department of Jobs, Enterprise and Innovation, Central Bank

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Alternative financing activities such as crowdfunding (including peer-to-peer lending) can be valuable sources of funding to micro and small businesses, either as a complement to traditional bank funding or as an alternative to traditional bank intermediation where bank credit has either been refused or not sought in the first place. To date, take up of crowdfunding in Ireland as a source of equity has been limited. There is currently no legislation in Ireland

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<sup>95</sup> Across all finance types, the rejection rate has slipped to 11 per cent from 15 per cent, and are now in line with the Eurozone average

<sup>96</sup> Just over a quarter of outstanding SME debt was in default in the first quarter, down from 41 per cent in 2013.

<sup>97</sup> European Private Equity and Venture Capital Association

regulating crowdfunding or the platforms that facilitate crowdfunding and the Central Bank's codes of conduct do not apply to crowdfunding platforms.

As a result, certain protections do not apply to consumers of crowdfunding, increasing the risks to potential investors and thus, weakening the attractiveness of such platforms. For example, crowdfunding platforms are not required to comply with client asset rules, and consumers of crowdfunding are not protected by the Deposit Guarantee Scheme or the Investor Compensation Company Limited (ICCL) scheme<sup>98</sup>.

The experience of the UK in the development and roll-out of alternative sources of finance, such as crowdfunding, suggests it is important that appropriate regulation of these activities is carried out<sup>99</sup>. The UK's Financial Conduct Authority (FCA) has sought to address and mitigate these risks through the introduction of regulation, and the FCA is now responsible for regulating investment-based crowdfunding and lending-based crowdfunding.

The introduction of this regulation in Ireland may help to legitimise crowdfunding, enhancing certainty and confidence in the model, and encouraging the expansion of alternate financing activity.

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**Recommendation:** Develop an appropriate regulatory framework for the crowdfunding market (including peer-to-peer lending) to enhance consumer confidence and encourage increased lending activity.

**Responsibility:** Central Bank, Department of Finance, SME State Bodies Group

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The Access to Finance survey also tracks the actions undertaken by SMEs in the aftermath of a rejection of an application for bank credit. The results indicate that 41 per cent of SMEs who have been rejected for bank credit do not seek finance elsewhere and simply forgo the search for finance after rejection. Consequentially, very few Irish SMEs either appeal the application with the lender or appeal to Credit Review Office<sup>100</sup>. In December 2015 the Central Bank published new regulations for lending to SMEs<sup>101</sup>. The regulations are aimed at providing SMEs with greater transparency around the loan application process (e.g. lenders will have to provide SME borrowers with written reasons for declining credit, and have to set up an internal appeals panel)<sup>102</sup>. The enhanced protections will only apply to micro and small enterprises with the previous SME Code (CP91<sup>103</sup>) continuing to apply for the benefit of medium-sized enterprises.

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**Recommendation:** Monitor the Central Bank's revised lending regulations for SME's to ensure that greater transparency around the loan application process is being achieved.

**Responsibility:** Department of Finance

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98 For further details see Central Bank of Ireland, Consumer Notice on Crowdfunding, including Peer-to-Peer Lending, Information Notice 17, June 2014

99 Financial Conduct Authority, A Review of the Regulatory Regime for Crowdfunding and the Promotion of Non-Readily Realisable Securities by Other Media, February 2015

100 The Credit Review Office provides an independent, impartial credit appeals process for small and medium sized businesses (SMEs), including sole traders and farmers.

101 Regulated lenders must comply with the new regulations from the second half of 2016. Credit Unions will have until the beginning of 2017 to comply with the new rules. Credit unions are not currently subject to the SME Code but will be subject to the SME regulations. For credit unions lending to SMEs, the regulations will therefore take effect six months later, on 1 January 2017. In conjunction with the publication of the SME Regulations, the Central Bank has published a feedback statement to the public consultation on the review of the SME Code (CP91).

102 This Panel will comprise at least two decision makers who have not been involved in the SME borrower's case previously, and who have sufficient knowledge and expertise to conduct the appeal.

103 Central Bank, Code of Conduct for Business Lending to Small and Medium Enterprises

### Addressing the Cost of Finance

The concentrated lending market in Ireland, coupled with higher credit risk, results in higher interest rates than the euro area average<sup>104</sup>. This remains an ongoing challenge for Irish businesses. Interest rates on non-financial corporation loans under €250,000 remain high relative to Eurozone averages for both lending to households and non-financial corporates. In both cases the margin (or wedge) between Irish rates and the EU average appears to be increasing through time<sup>105</sup>.

A number of important studies have been published by the Central Bank, exploring the factors driving this differential.

- Doheny and Flaherty find that interest rates applicable to SMEs differ from those granted to large NFCs<sup>106</sup>. In addition, the sector of economic activity within which an SME operates can impact loan pricing, as the perceived level of risk can vary significantly across economic sectors. In terms of new business, the average interest rate applied across the 15 SME sectors examined was 4.39 per cent in Q4 2015. However, individual SME sectors exhibited a wide range of prevailing interest rates. SME loans to the 'electricity, gas, steam and air conditioning supply' sector were just 2.79 per cent, while rates to the construction sector (5.89%) were markedly higher.
- The Central Bank's SME Market Report found that while the overall availability of credit has improved, the extension of credit to SMEs does not appear to be broadly based – in fact, negative growth was reported for a majority of sectors. The latest data release shows that businesses within the information and communication sector, in particular, have been driving the pickup in credit over the last three quarters. If the pickup in credit became broader across a variety of sectors, we would likely see a further improvement in employment and the benefit to the economy would likely be much more robust and sustainable.
- Carroll and McCann investigate the cause of differing credit costs for small and medium enterprises (SMEs) across the EU<sup>107</sup>. They find a significant positive relationship between interest rates and past/predicted SME loan defaults, and a negative relationship with the level of bank competition is found. Interest rates are also higher where banking stress is high and where unemployment is above historical levels<sup>108</sup>.

In light of these empirical findings, the Council believes that further adoption of credit risk mitigation policies is of paramount importance, and will help to further reduce interest rates. The Central Bank will this year begin the phased introduction of a national credit register (the "Central Credit Register"). The Register is a national mandatory database of credit intelligence that will be maintained and operated by the Central Bank, in accordance with the provisions of the Credit Reporting Act 2013. The aim of the Register is to provide lenders with a more comprehensive analysis of the creditworthiness of borrowers. The law underpinning the new register requires lenders to submit personal and credit information on loans of €500 or more. Lenders will also be required to consult the register when considering a loan application for €2,000 or more.

It is expected that the Register will produce credit reports for individual lenders after 31 December 2017. The collection of loan data from lenders will be implemented on a phased basis, with Phase 1 focusing on data collection for consumer lending and Phase 2 focusing on lending to businesses. Data submissions by lenders for Phase 1 will

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<sup>104</sup> Three Financial Institutions are prevalent in the lending market.

<sup>105</sup> ESRI, Quarterly Economic Commentary Summer 2016

<sup>106</sup> Doheny, G., and Flaherty, R., An Overview of the Enhanced Interest Rate Statistics for Ireland, Quarterly Bulletin No.2 2016, Central Bank, April 2016

<sup>107</sup> Carroll, J., McCann, F., Understanding SME Interest rate variation across Europe, Quarterly Bulletin No.2 2016, Central Bank, April 2016

<sup>108</sup> Conversely, measures of the cost of funds, banking sector profitability, and the recoverability of collateral do not have any association with SME interest rates.

commence from 30 June 2017 with all lenders required to submit data by 31 December 2017. The exact date for commencement Phase 2 is likely to begin around Q2 2018.

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**Recommendation:** Introduce the Central Credit Register for personal borrowers as planned and confirm the timeframe for the commencement of the business-relevant phase of the Register.

**Responsibility:** Central Bank

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As noted above, competition is a key vehicle to drive cost competitiveness. The Council welcomes the commitment in the *Programme for Partnership Government* to develop an overall banking policy that encourages more entrants into the Irish banking market with a view to creating a vibrant banking sector with real competition. However, given the highly concentrated nature of the Irish lending market and the absence of vigorous private competition, State-supported initiatives such as the Strategic Banking Corporation of Ireland (SBCI) assume a more central role<sup>109</sup>.

Encouraging and facilitating new entrants into the Irish market is one of the SBCI's main objectives and in July 2016 the SBCI and Bibby Financial Services Ireland (BFSI) launched a new €45m invoice financing fund for SMEs<sup>110</sup>. The new fund provides more favourable rates for BFSI's invoice finance facilities for Irish firms. Invoice financing frees up cash for companies, by providing them with upfront payments against the value of outstanding invoices. The deal marks the SBCI's first venture into invoice financing. Bibby Finance is now the seventh lender that the SBCI has a partnership with<sup>111</sup>. This followed the SBCI's partnership with First Citizen Finance which is offering a €50m fund for Irish agri-business SMEs seeking to buy or lease machinery.

The Council welcomes these partnerships and the delegation of responsibility for the Credit Guarantee and Counter Guarantee Schemes to the SBCI which will further increase the lending capacity of the Corporation.

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**Recommendation:** Partner the Strategic Banking Corporation of Ireland with more international lenders, especially in non-bank finance, so as to increase competition and provide alternative sources of finance for SMEs.

**Responsibility:** Strategic Banking Corporation of Ireland

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The total lending capacity of the SBCI amounts to €1.05 billion. The latest financial results show that while drawdown by SMEs has increased, SBCI provided only €347m to date to SME; it is unlikely, therefore, that all funds will be drawn down by the end of 2016 as planned. The level of lending to SMEs is driven by market demand, and it is understood that SBCI is engaged with a range of potential new on-lenders to broaden its distribution capability and market coverage.

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<sup>109</sup> The SBCI began lending in March 2015. Its goal is to increase the availability of funding to SMEs, at a lower cost and on more flexible terms, than has been available in recent times on the Irish Market. The SBCI channels its funds through lending partners known as on-lenders.

<sup>110</sup> Invoice financing is a specialist form of credit that allows SMEs to generate cash flow from invoices that have been issued but which have not yet been paid. Businesses that use invoice financing can improve their cash flow by getting cash upfront instead of waiting for their customers to pay their invoices. Invoice financing enables an importer or exporter who trades on an open account to raise pre or post shipment finance using commercial invoices and transport documentation.

<sup>111</sup> AIB, Bank of Ireland, Ulster Bank, Finance Ireland, Merrion Fleet and First Citizen Finance are the others.

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**Recommendation:** Increase the number of lenders and the uptake of SBCI loans. Secure additional funding for the SBCI once its current lending capacity has been fully drawn down.

**Responsibility:** Strategic Banking Corporation of Ireland, Ireland Strategic Investment Fund, Department of Finance

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Empowering consumers (both personal and business customers) to make informed choices is an important mechanism to drive competition. For example, in the residential sphere, from 2017 banks will be required to notify standard variable mortgage customers about alternative home loans so that consumers can avail of lower interest rates. The new rules, which are being introduced by the Central Bank, mean that banks must inform customers if they are on a higher interest rate than other products on offer by the same bank. The Council welcomes these initiatives and there may be merit in developing similar mechanisms for the SME sector<sup>112</sup>.

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**Recommendation:** Consider the development of an online cost of finance comparison tool for SMEs that will enable companies to quickly and reliably compare banks and banking products (in terms of price, quality of service and lending criteria) across the whole range of providers.

**Responsibility:** SME State Bodies Group

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<sup>112</sup> In the UK, the Competition and Markets Authority has proposed that banks should be made to regularly prompt their customers to check that they are getting good value from their banking provider. When these prompts direct customers to digital comparison services which give tailored price-comparison and service quality advice, the foundation has been laid for a major change in the retail banking sector. By making the prices and availability of lending products more transparent, the majority of SMEs need not, as is the case now, turn directly to their existing bank for finance without considering other offers.

## Chapter 5: Enhancing Talent and Skills

### Why Talent and Skills Matters for Competitiveness

The OECD defines talent as the global currency of the twenty-first century<sup>113</sup>. The availability of qualified work ready skills and talent is becoming the leading source of competitive advantage and key to competitiveness, innovation and growth. The availability of talent will increasingly be the fundamental differentiator in Ireland's value proposition for attracting and maintaining inward investment and export market growth.

Indeed, Ireland's standard of living can only be maintained and improved upon, through increasing productivity which in turn is facilitated and sustained by high levels of educational attainment. Macroeconomic performance is closely related to labour force skills: more skilled workers tend to be more productive and innovative and capable of disseminating productivity-improving technologies and processes.

At an individual level, labour force status, earnings inequality, health and wellbeing are all positively related to educational attainment, and the returns are particularly strong for higher levels of education. Qualifications alone, however, are not sufficient; the ability to effectively apply skills is what really matters in many occupations. For employers, the ability of those exiting the formal education and training system to be 'work-ready' is critical. Both domain-specific and generic and transferable skills are required.

Skills which everyone will require to access the labour market are moving beyond formal qualifications and the basics of literacy, numeracy, and using technology. There is an urgent need to substantially increase the integration of entrepreneurial, creative and analytical skills into all levels of the education and skills system, and to provide more of the transversal and cross sectoral skills in high demand by the enterprise sector.

### Current Context

As with so many other areas of policy, the skills, education and training sphere has been subject to significant focus and reform over the crisis years. *Ireland's National Skills Strategy 2025* represents an integral part of the Government's long term economic plan to restore full employment and to build a sustainable economy. It is closely aligned with broader Government policy including *Enterprise 2025*, *Pathways to work 2016-2020*, the *Action Plan for Jobs*, and the *Regional Action Plans for Jobs*, and the recently published *Action Plan for Education*<sup>114</sup>.

The skills agenda is an especially broad topic. The development of talent and skills occurs at all ages, and through a variety of interventions encompassing pre-primary, primary, and post-primary education, further education, higher education and lifelong learning (both formal and informal). The supply of skilled labour (and the development of an engaged, participative citizenry) depends on all elements of the education and training system working to the highest quality standards, efficiently, effectively and in harmony with each other. As per the *National Skills Strategy*, the active participation of employers in the development of skills is also a prerequisite for success. In this context, the recent establishment of *Regional Skills Fora* is a positive development.

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<sup>113</sup> Talent is a multidimensional concept but might usefully be considered the effective development and application of knowledge and skills, covering attitude, aptitude and potential. It covers domain-specific and generic skills. A growing body of economic and HR literature argues that developing skills and talent should focus on the quality of domain specific and generic skill requirements, across all levels of education and employment rather than attainment levels and education outputs.

<sup>114</sup> The *National Skills Strategy* is also cognisant of a range of additional publications and strategies which provide an important backdrop to the entire skills agenda. These include *Innovation 2020*, the *National Policy Statement on Entrepreneurship*, *International Financial Services 2020*, *Food Wise 2025*, *People, Place and Policy - Growing Tourism to 2025*, *Construction 2020*, *Trading and Investing in a Smart Economy – A Strategy and Action Plan for Irish Trade, Tourism and Investment to 2015*, the *National Digital Strategy*. A full list of existing and forthcoming education and training strategies is provided on page 11 of the new *Action Plan for Education*. See Department of Education and Skills, *Strategy Statement: Action Plan for Education 2016-2019*, September 2016

At a very broad level and from a competitiveness perspective, a number of priorities emerge, notably the need to:

- Address skills shortages across a range of occupations and sectors (e.g. ICT, engineering, sales, logistics, finance, and agri-food)<sup>115</sup> and the forecasted skills demand in the Biopharma sector<sup>116</sup>;
- Continue the modernisation and expansion of the apprenticeship system, particularly in relation to the rollout of the 25 new apprenticeship courses<sup>117</sup>. The issue of low female participation in apprenticeships must also be tackled;
- Boost the supply of ICT professional skills by, for example, maximising the output from the education system, use of the recently developed Techlife Ireland portal to attract key skills from overseas and implementing the decision to introduce a coding course at Junior Cycle and Computer Science as a subject at Senior Cycle<sup>118</sup>;
- Augment domestic skills resources with talent from abroad (Irish diaspora and foreign nationals) in areas where global demand is intense;
- Increase the supply of deep analytical skills talent (i.e. maths, statistics, analytical skills);
- Develop, publish and implement a National Foreign Language strategy<sup>119</sup>;
- Continue to improve the level of mathematical proficiency at all levels
- Increase the STEM skills pipeline at all educational levels, with a particular focus on increasing uptake by females.

In striving to achieve these goals, the engagement of both education and training providers and employers is required.

In terms of the providers they need to enhance career advice and information services; improve the alignment of provision between FET and Higher education to provide progression pathways for individuals at successive NFQ levels; engage enterprise in shaping the delivery of education and training skills provision; and ensure the continuing professional development of teaching staff to ensure what is taught is up-to-date.

Employer responsibilities include establishing occupational career paths (especially for lower skilled workers); developing the scale and range of new apprenticeships (this includes the provision of sufficient placements with employers); increasing the availability of placements, scholarships and internships; improving their talent retention practices; and enhancing their engagement with higher education institutions in relation to curriculum development<sup>120</sup>. Employers also have a role in promoting careers and enhancing understanding about potential roles within their own sectors – this is an important issue in areas such as financial services and ICT.

In recent Competitiveness Challenge reports, the Council has focused on the reform and evolution of Further Education and Training – with a particular focus accorded to the development of new approaches to apprenticeship. This year, reflecting two of the challenges identified in Ireland's Competitiveness Scorecard (discussed below), the Council is focusing on the Higher Education system, and on the need to boost participation in lifelong learning.

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<sup>115</sup> EGFSN, National Skills Bulletin 2015, July 2015

<sup>116</sup> EGFSN Future Skills Needs of the Biopharma Industry in Ireland, August 2016

<sup>117</sup> For more documentation on the reform of the apprenticeship system, see [www.apprenticeshipcouncil.ie](http://www.apprenticeshipcouncil.ie)

<sup>118</sup> There is forecast to be a continuing strong demand for high-level ICT skills across Europe that is unlikely to be satisfied because of ICT skills supply side constraints. A review of Ireland's ICT Action Plan is currently underway.

<sup>119</sup> The Department of Education and Skills committed itself (in Action Plan for Jobs 2015) to develop and publish a foreign languages strategy. A consultation process and forum, along with a separate stakeholder forum were held in 2015. The Action Plan for Education commits to publish the Foreign Languages in Education Strategy in Q4 2016. The Strategy will include new targets for foreign languages.

<sup>120</sup> The need for enhanced employer engagement on curricula development also applies to the Further Education sector.



### How Ireland Performs

Looking at some of the key metrics emerging from the Council's *Scorecard* report, overall Ireland performs relatively strongly in terms of skills development. According to the IMD's 2015 World Talent Report, Ireland is ranked 16<sup>th</sup> out of 60 countries in the world for the availability of talent.

Average educational attainment in Ireland has improved in recent years. Ireland has made significant progress in reducing the proportion of early school leavers (i.e. the proportion of the population aged 18-24 that have not completed post-primary education), and is now well below the EU and Euro-area averages reflecting higher retention rates in post-primary education. The most recent OECD data shows Irish PISA scores for maths, reading and science have improved since 2009 and, on average, Irish students score above the OECD-32 in all 3 categories. Third level education attainment rates are above the OECD-32 average. The proportion of the working age population with tertiary level education increased from 36 per cent in 2009 to 42 per cent in 2014.

There is a significant inverse correlation in Ireland between educational attainment and age; while a lower proportion of 45-54 and 55-64 year olds have attained tertiary education than the OECD average, a greater proportion of the remaining cohorts have a third level qualification than is the case in the OECD.

In terms of investment in education, Ireland ranks slightly below the OECD average and the gap is most pronounced at tertiary level; the gap in funding is particularly pronounced compared with the UK and US. While educational quality and outcomes are not simply a function of the level of expenditure, the Department of Education and Skills projects that continuing growth in the higher education sector will generate increased need for significant capital investment in areas such as new accommodation and facilities.

Investment and demographic trends also impact upon pupil numbers and pupil-teacher ratios. Data from the Department of Education and Skills shows that the numbers of pupils in Irish primary and secondary schools increased by 7.5 per cent and 7 per cent respectively in the period 2009-2014. Ireland had a student to teacher ratio of 16.4 in primary education in 2013. This was the seventh highest ratio in the EU. Ireland had the fourth highest student to teacher ratio for upper secondary education at 13.9 in 2013, for those EU countries for which data was available<sup>121</sup>.

Ireland's lifelong learning rate, at 7.2 per cent in Quarter 4 2015, is less than half the benchmark set by the EU under its Education and Training Framework (ET 2020<sup>122</sup>), which aims to engage 15 per cent of adults aged 25-64 in lifelong learning by 2020.

The National Skills Strategy highlights the progress made in improving the overall supply and stock of skills in recent years, but also points out that the quest to increase attainment levels is an ongoing challenge. A number of targets were set in the previous skills strategy, some of which used the National Framework of Qualifications (NFQ) as a reference point. Others focused on the percentages of learners completing their second level education as well as progression to higher education. Since 2007, particular progress has been made in the following areas:

- The number of learners completing senior cycle at second level increased from 81 per cent to 90.6 per cent. This exceeds the 90 per cent target set for 2020.
- 93 per cent of people aged 20-24 achieved an award at Levels 4-5 or more on the National Framework of Qualifications in 2014. This was an increase of 7 per cent on the baseline year of 2005 and just 1 per cent short of the target for 2020.

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<sup>121</sup> CSO, *Measuring Ireland's Progress*, 2014

<sup>122</sup> Education and training 2020 is the EU's framework for cooperation in education and training. It provides a forum for exchanges of best practices, mutual learning, gathering and dissemination of information and evidence of what works, as well as advice and support for policy reforms. In 2009, ET 2020 set four common EU objectives to address challenges in education and training systems by 2020, one of which was to make lifelong learning and mobility a reality.

- The progression rate to higher education increased by 14 percentage points, from 55 per cent to 69 per cent, while there was an 11 percentage point increase in the number of people in the labour force achieving a qualification at Levels 6-10 on the National Framework of Qualifications.

Progress was weaker in relation to some other targets. For example, the target to increase the percentage of people in the labour force holding a qualification at Levels 4-5 was not met. A challenge also remains in relation to the share of persons with NFO Level 3 as the highest level of education attained: at 15.4 per cent, this is still nearly double the 2020 target of 7 per cent.

## Policy Challenges and Recommendations

### Funding Higher Education

Ireland's Higher Education system responded strongly to the economic crisis, and in recent years, has committed to implementing significant reforms. The Higher Education Strategy to 2030<sup>123</sup> and the Higher Education System Performance Framework 2014-16 (which involves a process of strategic dialogue and agreement of compacts with publicly funded higher education institutions and the rollout of performance funding) represent key policy statements in this space<sup>124</sup>.

The demands on the Higher Education system are increasing – both in terms of capacity as ever more people complete post-primary education and seek to progress into higher education<sup>125</sup>, our growing population, and as a result of the increasing demands for higher skills levels from the enterprise sector. At the same time, the level of resourcing for higher education in Ireland is significantly lower than in most of our competitor countries. The latest international university rankings show another dip in standings for Irish third-level institutions, with Trinity College Dublin falling from 71<sup>st</sup> to 78<sup>th</sup> place, and UCD falling from 139<sup>th</sup> to 154<sup>th</sup> in the QS World University Rankings 2015-16. The latest drop in rankings for Ireland's top universities continues a five-year trend that is linked to cuts in funding domestically, and stronger competition from overseas.

There is a general recognition that given Ireland's ambition to increase our capacity and performance in higher education, the third level sector can no longer depend to the same extent on Exchequer funding<sup>126</sup>. The current model sees students contribute an average of €3,000 per annum, with direct Exchequer funding accounting for approximately 64 per cent of the total cost of Higher Education. The *Strategy for Investing in Higher Education* notes that while expected demographic changes could be funded through incremental year-on-year increases in the State's contribution, this would not be sufficient to address issues of performance and quality<sup>127</sup>.

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123 Department of Education and Skills, National Strategy for Higher Education to 2030: Report of the Strategy Group, 2011

124 The Performance Framework identifies a range of indicators that provide the HEA with a basis to assess how well the system is performing. The indicators range from targets set and agreed by Government in both national and international policy contexts, to more descriptive indicators included to reflect the level of different kinds of activity in the system. See HEA, Higher Education System Performance Framework 2014-2016, 2014

125 Tertiary attainment levels amongst the population aged 30-34 years has increased from 39.2 per cent in 2005 to 52.3 per cent in 2015. Department of the Taoiseach, National Reform Programme Ireland, April 2016

126 While the National Plan for Equity of Access to Higher Education 2015-2019 does not propose what the level of participation in higher education should be, the Plan is underpinned by the principle that everyone should have the opportunity to participate in post-primary education and that the population of new entrants to higher education should be broadly representative of the general population. The Department of Education, however, has a target that by 2020, 60 per cent of Irish 30-34 year olds should have completed tertiary or equivalent education. See HEA, National Plan for Equity of Access to Higher Education 2015-2019, 2016

127 Expert Group on Future Funding for Higher Education, Investing in National Ambition: A Strategy for Funding Higher Education, March 2016

While improved efficiency and additional commercial activity should be pursued, ultimately additional and reformed funding streams are necessary. The Strategy starkly concludes that amongst all of the various potential funding models that might be applied in Ireland, maintaining the status quo is not a valid option.

### The Current Model: HEA Recurrent Grant Funding Model

The Higher Education Authority is the statutory agency responsible for the allocation of exchequer funding to the universities, institutes of technology and other higher education institutions. Funding is distributed based on a "Recurrent Grant Funding Model" which contains three separate but related elements:

- An annual recurrent grant, allocated to each institution using a formulaic approach. Clarity, transparency and fairness as to how the institutions are funded are key objectives, with uniformity of core grant allocation for students in the same broad areas, regardless of the institution at which he/she chooses to study and recognition of the extra costs which arise in the case of students from under-represented backgrounds.
- Performance related funding, benchmarked against best national and international practice, with emphasis on setting targets and monitoring outputs. Ultimately it is proposed up to 10 per cent of the annual core recurrent grant will be linked to performance by HEIs in delivering on national objectives set for the sector.
- Targeted/strategic funding which supports national strategic priorities and which may be allocated to institutions on a competitive basis.

In terms of the scale of expenditure and investment required to support our Higher Education ambitions, it is estimated that at present Higher Education Institutions (HEIs) receive €1.8 billion in state grants, student fees and other income streams; the Expert Group on Future Funding for Higher Education estimate that this needs to increase to €2.4 billion by 2021 and to €2.8 by 2030. A capital investment programme of €5.5 billion is also required over the same period, while it is also estimated that an additional €100 million is required in student supports (bringing the total to €270 million per annum).

Essentially, the *Strategy* proposes three possible alternate funding approaches. The first would see a predominately State-funded model – with Exchequer funding accounting for up to 80 per cent of total costs. This amounts to an additional €1.3 billion of State funding per annum (over and above 2015 levels) to be provided through general taxation. The second option is based on increased State funding (of about €1 billion) in parallel with a continuation of up-front student fees at roughly existing levels. This would bring the State's proportion of the total cost to 72 per cent<sup>128</sup>. The final option proposed is based on increased State funding alongside the introduction of deferred student fees (i.e. "moderate" fees financed through income contingent loans). Depending on the level of student fee applied (€4,000-€5,000), the State's proportionate contribution declines (55-60 per cent), although the total amount increases (€563-€711 million).

A decision on the overall approach to funding is required from Government before any changes can be made to the current model. In determining the model to be applied, there are a number of principles, outlined in the *Strategy*, which should be adhered to. The funding model should:

- Take a systems wide perspective that provides certainty and consistency to all higher education stakeholders, and should be attuned to all of the various incentives and factors that shape demand for higher education. It should also be administratively simple and easy to explain.

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<sup>128</sup> It is estimated that every €250 reduction in student fees would require an additional €16 million in state funding.

## Ireland's Competitiveness Challenge 2016

- Align and support Ireland's national ambitions to provide high quality experiences and outcomes (as outlined in various strategies including the National Skills Strategy and Innovation 2020). It should also facilitate an increase in resources and adjust in response to changing conditions and outcomes.
- Support an increase in quality of the undergraduate learning experience, competences, and qualifications, across a broad range of disciplines, yielding knowledge of economic, social and cultural value.
- Enhance access, participation and progression across all socioeconomic groups. It should also result in a system that is open to all learners, not just traditional full-time, post leaving certificate students<sup>129</sup>.
- Provide fairness and balance with a sharing of costs which reflects, to the degree possible, the benefits accruing as a result of access to higher education.

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**Recommendation:** Develop and implement a funding model that allows for increased participation and quality in higher education. The funding model should reflect the principles outlined by the Expert Group on Future Funding for Higher Education in relation to certainty and consistency; meeting national ambitions; supporting an increase in quality; enhancing access and participation; and ensuring fairness and balance.

**Responsibility:** Department of Education and Skills, Higher Education Authority

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Given the current challenges, and the scale of the ambition outlined above, any delay in addressing the funding shortfall will serve to exacerbate the situation. Therefore, decisive action is required as a matter of urgency. The sooner a decision is made in relation to the approach to be taken, the sooner parents, students and institutions can start to plan.

The Council supports the view of the Expert Group that a combination of State funding and deferred payment of fees (with income contingent loans) is the most appropriate model for Ireland. This view is based on the fact that it shares the cost of education and reflects in part the returns expected as a result of the investment (e.g. improved employability and higher incomes for graduates, in addition to wider societal and enterprise benefits). The absence of student fees would necessitate a significant increase in central funding, which in turn could only be financed through increased general taxation and/or borrowing. The role of employers in funding higher education should also be considered. The contribution of employers is also worth revisiting. Any additional contribution made through the National Training Fund (NTF), for example, would need to link educational outcomes to the skills needs of enterprise. If a fee based model was to be implemented, independent regulation of fee structures will be required.

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**Recommendation:** Introduce a funding model for higher education that combines increased State funding alongside deferred payment of fees through income contingent loans (as per the recommendation of the Expert Group). Establish an implementation group to design and deliver the preferred funding model.

**Responsibility:** Department of Education and Skills, Higher Education Authority, Higher Education Institutions

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<sup>129</sup> Equity of access to higher education is a fundamental principle of Irish education policy. The vision set out in the recent National Plan for Equity of Access to Higher Education is that "the student body entering, participating in and completing higher education at all levels reflects the diversity and social mix of Ireland's population". A range of targets for particular cohorts of the population are outlined in the Plan. See Department of Education and Skills, National Plan for Equity of Access to Higher Education, December 2015

Currently, Student Universal Support Ireland (SUSI) - which is Ireland's single national awarding authority for all higher and further education grants – is undergoing a process of reform to achieve significant improvements to its systems and procedures. The purpose of these reforms is to streamline the grant application, processing and payment processes. However, problems with access and participation persist: the European Commission has noted that "access and equity in tertiary education are problematic for disadvantaged socioeconomic groups...Young people with a more disadvantaged socioeconomic background are less likely to attend university given their insufficient educational achievement at upper secondary school and financial constraints"<sup>130</sup>.

Regardless of the funding approach taken, from an equity and efficiency perspective it is vital that adequate and targeted supports are in place to facilitate participation in higher education from all parts of society. It would appear that education that is free at the point of access may offer the best route to encourage students from low income households to participate. As well as a robust and timely system of student supports, it is vital that supports are targeted at those who are most in need. Changes to existing funding approaches or student supports would need to be carefully monitored to ensure that impact upon participation is positive.

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**Recommendation:** Enhance the current model of student support to ensure that it is appropriately targeted to assist those most in need, taking account of higher education fee structures, living costs and other maintenance costs.

**Responsibility:** Department of Education and Skills, Higher Education Authority

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### Lifelong Learning

Lifelong learning is important to competitiveness as it facilitates structural adjustment, productivity growth, innovation and effective career progression<sup>131</sup>. The concept is broad and covers the whole lifecycle and comprising all forms of formal, non-formal, and informal learning. The Europe 2020 Strategy sets a target that an average of at least 15 per cent of adults aged 25 to 64 years should participate in lifelong learning.

Based on Eurostat data, in 2015 the proportion of persons in Ireland receiving some form of education or training in the four weeks preceding the labour force survey was 6.5 per cent, compared with the EU28 average of 10.7 per cent. Further, survey data from the OECD's Programme for the International Assessment of Adult Competencies (PIAAC) shows the levels and distribution of skills among the Irish working-age population are relatively low compared with competitor countries in terms of literacy, numeracy and digital skills.

More recent analysis of *national* data from the CSO's Quarterly National Household Survey shows that in Quarter 4 of 2015, Ireland's participation in lifelong learning was 7.2 per cent<sup>132</sup>. Other key findings in the Expert Group on Future Skills Needs (EGFSN) report are:

- In Ireland, 177,300 people aged 25-64 years participated in Lifelong Learning activities in Quarter 4 2015;

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<sup>130</sup> European Commission, Recommendation for a Council Recommendation on the 2016 National Reform Programme of Ireland and Delivering a Council Opinion on the 2016 Stability Programme of Ireland, COM(2016) 328, May 2016

<sup>131</sup> Lifelong learning comprises formal, non-formal and informal education and training; however, statistics presented in the QNHS and Eurostat data do not cover informal learning. Formal education corresponds to education and training in the regular system of schools, universities, colleges and other formal educational institutions that normally constitute a continuous 'ladder' of full-time education for children and young people. Non-formal education and training is defined as any organised and sustained educational activities that do not correspond to definition of formal education. It may or may not take place in educational institutions. It may cover educational programmes to impart adult literacy, basic education for out-of-school children, life skills, work skills, and general culture.

<sup>132</sup> The CSO and Eurostat data sets are not directly comparable as the QNHS data is a quarterly figure based on Quarter 4 2015, while the Eurostat figures are based on an annual average. See EGFSN/SOLAS, Lifelong Learning Among Adults in Ireland, July 2016

- The majority of these (amounting to 116,700 persons) participated in formal learning activities (i.e. education and training in the regular system of schools, universities, colleges and other formal educational institutions);
- The remainder participated in non-formal learning activities (i.e. other organised and sustained educational activities which may or may not take place in educational institutions);
- Females (8%) were more likely than males (at 6.3%) to participate in Lifelong Learning;
- Lifelong learning participation rates tend to decline with age, but participation is greater amongst those with higher educational attainment levels;
- Participation rates were above the national average for the economically inactive and the unemployed, while the rate was below the national average for those in employment;
- Ireland's participation rate in non-formal learning is particularly low, although its rate of formal learning is amongst one of the highest in the EU.

The EGFSN report identified a number of clear shortcomings in Irish participation rates vis-à-vis the EU, notably in relation to non-formal learning (2.4 per cent compared with 8.1 per cent); amongst the employed (5.5 per cent compared to 11.6 per cent); amongst third level graduates (9.8 per cent compared to 18.8 per cent); and amongst younger age cohorts (11.5 per cent compared with 17 per cent).

Given the evidence of skills mismatches, low levels of formal attainment and other labour market challenges discussed elsewhere in this report, lifelong learning assumes even more importance as a vehicle through which labour market performance and employability can be enhanced. OECD research has shown a positive relationship exists between participation in lifelong learning and reduced skill mismatch reinforcing the importance of upskilling through both on the job-training and opportunities for lifelong education and training.

The new National Skills Strategy and the Action Plan for Education offer a timely opportunity to reinvigorate the lifelong learning agenda. At present, objectives for Lifelong Learning and the actions to achieve these objectives are spread across numerous reports and strategies. However, the Action Plan outlines a measurable overarching objective in relation to participation in lifelong learning.

Action Plan for Education: Increase to 10 per cent the number of those aged 25-64 engaged in lifelong learning by 2020 (from a 2015 rate of 7.2 per cent), and to 15 per cent by 2025.

*Department of Education and Skills*

All of the other relevant education and skills strategies which make reference to increasing participation in lifelong learning should work towards achieving this overall objective. Learning opportunities for those in the workplace need to be expanded and to occur on a more frequent basis throughout workers' careers. This is particularly relevant within the framework of Ireland's National Skills Strategy 2025 where one of the key actions (Action 4.1) aims is to promote the benefits of lifelong learning among individuals, the self-employed and employers. The Strategy recognises the role of increasing participation in lifelong learning in ensuring Ireland has a flexible, skilled workforce, where individuals (including low-skilled and older workers) can gain the skills to move between jobs and careers throughout their working lives. Participation in lifelong learning offers additional, societal benefits. For example, embedding digital skills in the general population can facilitate greater participation in society.

While in most EU countries, lifelong learning rates are driven by participation in non-formal learning activities, in terms of the benefits from a competitiveness and enterprise perspective, the focus in Ireland should be on increasing

participation in formal learning, especially for the low skilled, whilst simultaneously recognising the value of participation in informal learning. In this context, the Action Plan for Education commits to:

- Reducing the proportion of 18 to 24 year olds with at most secondary education and not in further education or training; and
- Reducing the percentage of the labour force at levels 1-3 on the National Framework of Qualifications from 15 per cent to 7 per cent.

These challenging targets emphasise the importance of promoting participation in formal learning to the extent possible. Where informal learning is required – particularly for low skilled workers, the Recognition of Prior Learning (RPL) is an important supporting mechanism to boost participation in lifelong learning. RPL supports access, transfer and progression across all levels of the education and training system. RPL is also an important vehicle in encouraging participation in on-the-job or in-company training<sup>133</sup>.

Best practice also suggests that RPL can be used for broader purposes, including social inclusion and equality of opportunity. Despite improvements, there remains a deficit in relation to the development of system-wide capacity for RPL. While there is established good practice in RPL across the Higher Education system, and through programmes such as Springboard and Momentum, there is still a need to build on the progress already made. The Action Plan for Education commits to the development of a national policy on RPL by 2018<sup>134</sup>. To achieve this, mechanisms are required to:

- Increase learner choice in qualifications;
- Provide greater flexibility in course provision where feasible – for example, delivery of courses through innovative and blended channels should become more commonplace, and the current emphasis on having learners present in class should be reviewed;
- Create new routes to attaining qualifications;
- Enhance quality assurance/recognition of qualifications; and
- Optimise stakeholder involvement in curricula delivery and design.

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**Recommendation:** Ensure that a coordinated approach to meeting the lifelong learning objectives outlined in the Action Plan for Education is applied across all of the relevant education and training strategies.

Prioritise actions to increase participation in formal learning, with a particular focus on engaging low skilled workers. As well as making it easier to participate in lifelong learning, there is a need to communicate the benefits and returns which accrue through participation to potential learners and to employers.

**Responsibility:** Department of Education and Skills, Higher Education Institutions, Education and Training Boards, private education and training providers, employers

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<sup>133</sup> The issue of in-company training is particularly pressing for SMEs: OECD data shows that SMEs participate in 50 per cent fewer training activities than large firms. See OECD, Skills Development and Training in SMEs, 2014

<sup>134</sup> The Expert Group on Future Skills Needs has previously published a report and a series of recommendations to support the development of a comprehensive system of RPL. Recommendations are targets at specific cohorts of the population according to their attainment level and cover issues such as guidance, information provision, programme provision, job referrals, and standard setting. See EGFSN, Developing Recognition of Prior Learning: The Role of RPL In the Context of the National Skills Strategy Upskilling Objectives, April 2011

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**Recommendation:** To support an expansion in informal learning, continue to develop a common understanding and national framework to facilitate the recognition of prior learning across all levels of education and training.

**Responsibility:** Department of Education and Skills, Quality and Qualifications Ireland

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In this regard, the NTF represents a vital funding vehicle for lifelong learning – and the ongoing decline in unemployment provides an opportunity to refocus investment in lifelong learning and enterprise-relevant in-company training, particularly focused on low skilled workers. In 2016, the NTF is expected to raise €382 million: 23 per cent of NTF expenditure is on training for those in employment with 77 per cent dedicated to training for the unemployed.

There is a strong case to be made to rebalance this expenditure over time and to provide additional support to in-employment training<sup>135</sup>, whilst recognising the additional demands that are likely to arise on the fund from the expansion of the apprenticeship system. Any reallocation of NTF funding should be used to address identified skills shortfalls. In this regard, SOLAS' forthcoming Workforce Development Plan offers an opportunity to better target State supports for in-company training through the Further Education and Training system<sup>136</sup>.

On the Higher Education side, the implications of Brexit and the need to diversify the markets into which Irish companies sell (see Chapter 9 for more detail) places greater importance on the availability of workers with international selling skills and foreign language abilities. For example, the EGFSN previously noted that an improved supply of domestic foreign languages capability (numbers, range and proficiency) would act as a major boost to the enterprise sector achieving its growth potential<sup>137</sup>. The HEA's National Employer Survey also indicated the importance of enhancing the supply of foreign language skills – 25 per cent of employers indicated that they had a specific requirement for foreign language proficiency skills in their organisation<sup>138</sup>. Languages of particular strategic importance include German, French, Spanish, Italian, and emerging languages such as Mandarin Chinese, Japanese, Russian and Arabic (at relatively lower numbers).

In developing a strategy to improve foreign language capability, we must be cognisant of the EU's adopted ambition that each citizen should speak two languages in addition to their mother tongue. The forthcoming Strategy – due to be published in Q4 2016 - should aim to distinguish Ireland amongst other English speaking countries as the one with both the highest standard of English and the highest levels of multilingualism. Ensuring that language teaching facilitates professional functionality, fluency and active language use is essential.

In line with previous commentary about the importance of employer engagement in skills development, it would be extremely beneficial if more undergraduate and graduate internships within companies operating in overseas markets (where English is not the first language) were available. This would also support the contextualisation of language teaching – another important element of successful foreign language teaching.

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<sup>135</sup> In-company training is relevant across all sectors and occupations. For example, the EGFSN highlights the need to enhance continuing professional development through in employment training amongst those employed in the biopharma sector. See EGFSN, Future Skills Needs of the Biopharma Industry in Ireland, August 2016

<sup>136</sup> The Workforce Development Plan is an FET policy framework for employee skills development. It will cover what the FET sector can do to assist employers and employees to address skills issue with an initial focus on the low skilled.

<sup>137</sup> EGFSN, Key Skills for Enterprise to Trade Internationally, 2012

<sup>138</sup> Higher Education Authority, National Employer Survey: Employers' Views on Irish Further and Higher Education and Training Outcomes, May 2015



**Recommendation:** Allocate a larger proportion of the National Training Fund to upskill people in employment as unemployment declines. This funding should be targeted at areas where specific enterprise needs have been identified.

**Responsibility:** Department of Education and Skills

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**Recommendation:** Complete and publish the National Foreign Languages in Education Strategy in Q4 2016. The Strategy should be developed with a 5-10 year vision to provide an integrated and coherent approach to foreign language teaching in all learning contexts. Establish the language advisory group to drive implementation in Q1 2017 as outlined in the Action Plan for Education.

**Responsibility:** Department of Education and Skills

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Finally, the Council has long been an advocate of linking funding and performance across the public sector. The HEA has (since 2013) undertaken a series of strategic dialogues with individual Higher Education institutions. The goal of this process is to make the 'independent' institutions more accountable for outcomes achieved. Each institution has now entered into a compact with the HEA, undertaking how it will contribute to national objectives from the position of its particular mission and strengths. The Council has long been an advocate of linking public funding and performance. In the higher education sector, each institution has now entered into a compact with the HEA, outlining how it will contribute to national objectives from the position of its particular mission and strengths. The compacts provide for how performance is to be measured and a proportion of funding will, in future years, be contingent on performance.

The initial focus of the dialogue between the HEA and the higher education institutions has necessarily been more on planning and establishing baselines, than on performance and outcomes. The HEA has tested the plans submitted by the higher education institutions against previous institutional performance, national targets and policy. In this first year of strategic dialogue, the HEA withheld €5 million in funding for the institutions, contingent on satisfactory engagement with the dialogue process. Following a review of engagement, all institutions were judged to have met the required standard and the funding was released. Progressively, over further iterations of strategic dialogue, we will move to a stronger focus on performance against agreed targets, with funding implications.

Having established a baseline, it will now be possible to both steer and track system performance on an annual basis. The introduction of the System Performance Framework coupled with the Strategic Dialogue process and performance funding provides a coherent and structured framework for a changed relationship between the State and the higher education sector in the future. Overall these changes are intended to create a more dynamic, responsive and high quality higher education sector with a strong network of outward facing institutions with critical mass and the strengths in research, innovation and teaching to support economic well-being, helping to raise the international profile and performance of Ireland's institutions.

This process provides an opportunity to reinforce the important links between the education system and the enterprise sector. There is merit in making a larger proportion of public funding contingent on meeting identified skills needs, at both national and regional level, than is presently the case<sup>139</sup>. Specifically, the HEA should use its Strategic Dialogue process with the HEIs and the regional clusters to keep labour market skills needs high up the HEIs' agenda.

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<sup>139</sup> In August 2014 it was recommended that initially up to 7 per cent of recurrent funding be performance related annually (5 per cent determined conditionally, and 2 per cent based on other competitive criteria). See HEA, HEA Proposals – Performance Funding, August 2014

Further, the HEA should examine how, as an outcomes-based approach, the HEI Performance Compact can be utilised in the short term to address identified labour market skills shortages such as ICT, data analytics, sales and foreign language skills.

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**Recommendation:** Reform the funding model for Higher Education to support the growth ambitions and the capacity to meet specific targets on identified skill gaps in areas such as ICT, data analytics, sales and foreign language skills, in the context of the Higher Education System Performance Framework 2017-2019.

**Responsibility:** Higher Education Authority

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## Chapter 6: Fostering Productivity Growth

### Why Productivity Matters for Competitiveness

Productivity is a key driver of national competitiveness. Improving levels of labour and capital productivity enables enterprises to improve their efficiency and profitability, and enhances the ability of countries to maintain international competitive advantage and sustainably improve living standards.

Productivity growth enables Irish firms to compete successfully in international markets by facilitating output to be produced in a more efficient and effective manner. Productivity growth depends on the performance of individual firms which is largely beyond the direct control of policy makers. However, the resources that enterprises draw on to maximise productive capability are multi-dimensional and come from the surrounding competitiveness environment, including, for example, a sound macroeconomic environment, the education and skills base of the labour force, transport and communications networks, science and technology, capital investment, competition and regulation policies, and access to finance.

In the long-run, productivity is the primary determinant of improvements in national living standards. As well as impacting on domestic living standards, differences in relative productivity performance are responsible for different rates of economic growth between countries. Research by the OECD suggests a possible link between declining productivity and rising income inequality, as growing productivity dispersion across firms contributes to a widening of the wage distribution.

### Current Context

For the past fifteen years productivity growth has been subdued in most OECD countries. The global slowdown in productivity growth has been attributed to a mix of cyclical factors such as low investment in physical capital, in a context of weak global demand and structural factors such as inefficient markets, low levels of innovative start-ups and skills mismatch<sup>140</sup>.

Productivity in the euro area is considerably lower than in the US: according to OECD data, productivity levels in the euro area were just 84 per cent of the US level in 2014. This differential has remained constant over the past ten years. The gap between European productivity growth levels and US growth has been attributed to differences in business structures, lower levels of R&D and capital investment, market barriers and regulation and insufficient adoption and use of ICT<sup>141</sup>. In addition, higher costs (particularly energy), infrastructure pressures, and fewer available sources of finance make the European operating environment for enterprise relatively less productive. Within the euro area, there is large variation in productivity growth rates between economies, reflecting the different states of the economic cycle, employment structure, labour market, and the intensity of ICT and capital investment.

The widespread weakness in productivity growth among major European countries points to an inability to translate technology and innovation to productivity growth, weak demand and low investment as well as an increased negative impact of structural rigidities in labour, capital, and product markets. In Ireland and other OECD member states, the rate of productivity growth varies across economic sectors, with global (exporting) sectors and firms performing best and larger, domestically focused indigenous sectors performing poorly. In Ireland, the superior productivity performance in terms of value added per hour worked in exporting sectors such as ICT and manufacturing is striking.

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<sup>140</sup> OECD, The Productivity-Inclusiveness Nexus, 2016

<sup>141</sup> European Commission, European Competitiveness Report 2013: Towards Knowledge-Driven Reindustrialisation, 2013

Just as productivity performance differs between countries, and sectors, so too it differs at firm level. The OECD classifies firms into three cohorts based on their productivity performance: the globally most productive firms (i.e. global frontier firms); the most advanced firms nationally; and laggard firms. The interaction between these three cohorts combines to determine overall productivity performance. While productivity growth rates amongst the global leaders remains strong, the gap between high productivity firms and the rest has increased. The OECD concludes that *"the main source of the productivity slowdown is not so much a slowing of innovation by the most globally advanced firms, but rather a slowing of the pace at which innovations spread throughout the economy: a breakdown of the diffusion machine"*<sup>142</sup>.

From a policy perspective, there is increased emphasis nationally and internationally on the role and drivers of enterprise productivity as a means of facilitating economic growth. In 2015, the Irish Government published Enterprise 2025, a strategy which sets out a range of cross sectoral initiatives designed to support the enterprise sector. Enterprise 2025 aims to enhance our relative competitiveness, leverage existing comparative advantage in key sectors, address structural issues in the economy, enhance the capacity of enterprises to innovate and improve productivity. A key target of the strategy is to deliver 2-2.5 per cent productivity growth per annum in Irish companies.

From an international policy perspective, there is increased emphasis on the role of and drivers of productivity as a means of facilitating economic growth. In particular, the prolonged slowdown in global productivity has been subject of considerable debate across advanced economies in recent years.

The OECD's 2015 Economic Survey of Ireland recommended that Ireland develop a stronger whole-of-government productivity agenda. In addition, in 2015 the OECD launched a Global Forum on Productivity (GFP) to foster international co-operation between public bodies with responsibility for promoting productivity-enhancing policies. There is also an increasing emphasis being placed on productivity at European level. Arising out of the 2015 report "Completing Europe's Economic and Monetary Union" (referred to as the Five President's Report), the European Council adopted a Council Recommendation on euro area National Productivity Boards to systematically track developments and inform national debate in relation to productivity and competitiveness.

The productivity challenge for Ireland is to broaden the enterprise productivity base and ensure that new job generation is coupled with productivity growth. While many of Ireland's large, export focused sectors record impressive productivity growth, performance is weaker amongst domestically focussed companies and sectors, particularly in large employment sectors such as accommodation and food, retail, agriculture, and construction. Productivity challenges also persist in relation to measuring and enhancing productivity in the public sector.

### How Ireland Performs

OECD data indicates that in terms of output levels (i.e. GDP per hour worked), Irish labour productivity levels improved considerably in the past five years with average annual growth of 2.7 per cent. Using OECD data, Ireland's output per hour was \$62.02 in 2014, an increase of 6.5 per cent on 2010 and a 21.9 per cent increase compared with 2004<sup>143</sup>. This represents the fifth highest labour productivity level among OECD member states, after Luxembourg, Norway, the US and Belgium. Over the period 2004-2014, Ireland had the seventh highest increase in output per hour in the OECD, behind Korea, Estonia, Slovakia, Poland, Chile and Hungary.

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<sup>142</sup> OECD, The Future of Productivity, 2015

<sup>143</sup> Measured in US Dollars, constant prices, 2010 Purchasing Power Parity applied.

Labour productivity growth in Ireland is exceptionally strong. At 3.1 per cent, the growth rate of Irish (GDP) productivity per hour worked exceeds the OECD average (1.5%). However, if measured using GNP per hour worked, Ireland's relative position declines significantly<sup>144</sup>.

Despite the positive trends in productivity performance, the composition of Irish economic activity and employment has a big impact on Irish productivity growth. Ireland's productivity performance (in common with many other countries) is built upon a narrow base of sectors, and indeed, in some cases, companies. The contribution of an individual sector to overall productivity growth is dependent on its productivity growth and share in total value added and hours worked. Examining the value added component of economic activity in Ireland shows that high value added sectors such as ICT and chemicals boosts measures of Ireland's overall productivity performance, and disguises to a degree, underperforming sectors.

Labour productivity levels and growth rates generally tend to be higher in the manufacturing sector compared to the services sector. OECD data shows significant divergence at sectoral level in terms of output per hour<sup>145</sup>. In 2014, output per hour worked in Ireland was highest in the ICT sector (€133), manufacturing (€81) and lowest in construction (€12) and agriculture (€9). Over the period 2009-2014, the main contributions to Irish productivity growth have been in ICT and manufacturing with negative contributions from construction and financial services.

As highlighted by the OECD, average labour productivity in large manufacturing firms is significantly higher in Ireland than in many other countries. This is a reflection of the high intellectual property content of output in Ireland, typically provided by multinational firms<sup>146</sup>. The presence of foreign multinationals in Ireland, therefore, has a significant impact on measures of Irish productivity.

Assessing productivity in terms of value added per person employed, firm size appears to matter. In most countries there is a significant productivity gap between micro, small and medium-sized firms compared to large firms<sup>147</sup>. In Ireland, in the period 2008-2012, labour productivity amongst micro firms in the manufacturing sector was 60 per cent less than that of larger firms; the gap between medium and small firms compared to large firms was 84 per cent and 66 per cent respectively. The gap is less pronounced in the services sector.

Labour productivity metrics only partially reflect the actual productivity of labour (i.e. the personal capacities of workers or the intensity of their effort). The ratio between the output measure and the labour input depends to a large degree on the presence and/or use of other inputs (e.g. capital, intermediate inputs, technical, organisational and efficiency change, economies of scale).

Multifactor productivity (MFP) reflects the overall efficiency with which labour and capital inputs are used together in the production process. Changes in MFP reflect the effects of changes in management practices, brand names, organisational change, general knowledge, network effects, spill overs from production factors, adjustment costs, economies of scale, the effects of imperfect competition and measurement errors. Growth in MFP is measured as a residual (i.e. that part of GDP growth that cannot be explained by changes in labour and capital inputs). In simple terms, therefore, if labour and capital inputs remained unchanged between two periods, any changes in output would reflect changes in MFP.

Prior to the crisis, MFP growth in most OECD countries contributed strongly to productivity growth. In the period 2007-2013 MFP growth decelerated in nearly all countries. Irish MFP grew by 1 per cent in 2001-2007 and decreased by 0.35 per cent in the years 2007-2013. Investment in knowledge based capital includes investment in computerised

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<sup>144</sup> Productivity using GNP figures should be interpreted with caution as GNP tends to be more accurate measures of national income as opposed to output.

<sup>145</sup> OECD Productivity Database, measured as gross value added per hour worked at constant 2010 prices in national currency.

<sup>146</sup> OECD, Compendium of Productivity Indicators, 2016

<sup>147</sup> *ibid*

information, innovative intellectual property and economic competencies. As shown in this year's *Scorecard Report*, while such investment has grown over time, Ireland remains in the lower half of OECD countries for which data is available. Ireland has a higher proportion of innovative enterprises than both the EU28 and euro area-19 averages in product, process and marketing but performance is relatively weak in terms of organisational innovation.

While Irish productivity levels are higher than the OECD average, the contribution of productivity to economic growth is less pronounced in Ireland than many other OECD member states. Economic growth can be increased by increasing the amount and types of labour and capital used in production, and by attaining greater overall efficiency in how these factors of production are used together (i.e. through higher MFP). While productivity growth in Ireland contributes positively to overall growth, the effect of this is somewhat undermined by the negative contribution of hours worked. The negative contribution of hours worked over the period 2009-2013 reflects changes in labour market composition.

The quality of the public sector institutional environment - which determines the legal and administrative framework within which individuals, firms, and governments interact - has a strong bearing on competitiveness. Ireland ranks above the OECD average in terms of perceptions of the quality of public services, the quality of the civil service the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. The Council believes that ensuring that the public service is optimal in terms of efficiency and effectiveness is a critical productivity consideration.

### Policy Challenges and Recommendations

Productivity is a multi-dimensional concept; it reflects our ability to produce more output by better combining inputs, ideas, innovations and new business models. The most important policy considerations for increasing productivity identified by international institutions such as the OECD, IMF and European Commission, are set out in other chapters in this report. These include sound macroeconomic fundamentals, a regulatory environment favourable to enterprise, access to finance, educational attainment and infrastructure.

Given the complex nature of productivity, it is difficult, therefore, for policy makers to directly impact national productivity performance through one simple reform path. Instead, policy must focus attention on various levers at national level which can, over time, enhance the capability of firms and individuals to effect change and boost performance.

The prominence accorded to productivity performance in Enterprise 2025 (EP2025) and Food Wise 2025 is welcome<sup>148</sup>. Taking a whole of enterprise approach, EP2025 sets out a range of actions to facilitate improved productivity performance through improving collaboration amongst firms and sectors, boosting internationalisation, fostering emerging sectors, and stimulating innovation are all set out. Food Wise 2025 also places a strong and welcome emphasis on increasing productivity growth, particularly through innovation and technology.

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<sup>148</sup> Food Wise 2025 sets out the key actions required to ensure that the agri-food sector maximises its contribution to economic growth and exports in an environmentally sustainable manner over the coming decade.

**Recommendation:** Prioritise and implement the actions to support productivity set out in Enterprise 2025 and Food Wise 2025. Track implementation and monitor the impact of the actions on key metrics including productivity performance.

**Responsibility:** Department of Jobs, Enterprise and Innovation, Enterprise Ireland, IDA Ireland, Local Enterprise Offices, Department of Agriculture, Food and Marine, Bord Bia, Teagasc, Bord Iascaigh Mhara

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The Council acknowledges and welcomes the renewed focus on productivity and competitiveness at European and OECD level as set out in the European Commission's 2016 draft recommendation on the establishment of Productivity Boards and the launch of the OECD's Global Forum on Productivity. The Council believes that there is merit in national competitiveness and productivity bodies, the Commission and the OECD cooperating and exchanging best practice in the field of productivity research and practice. There are good opportunities for mutual learning; particularly in terms of the design of effective policies to enhance productivity and national competitiveness, while taking into account the heterogeneity of individual countries' economic performance and priorities.

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**Recommendation:** Engage with international competitiveness and productivity related bodies and forums to foster productivity-enhancing policies.

**Responsibility:** National Competitiveness Council

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The policy mix that best supports robust and broader based productivity growth varies between countries reflecting country-specific conditions. Given the range of factors that influence productivity, the impact of reforms on productivity growth will vary considerably between countries<sup>149</sup>. Building on the OECD's research in the Future of Productivity report, the Council believes that the following factors are particularly important in relation to enhancing Irish productivity performance:

- Extending global connectedness, via trade, FDI, and participation in Global Value Chains (GVCs);
- Fostering innovative indigenous start-ups, scaling and improving survival rates;
- Deepening innovation capacity, capability and activity at firm level, particularly in indigenous SMEs (and Ireland's non-exporting sectors).

### Extending Global Connectedness, via Trade, FDI and Participation in Global Value Chains (GVCs)

As a small open economy, Ireland's ability to achieve sustainable growth is dependent on our ability to trade internationally and maintain export competitiveness. Trade can facilitate productivity growth in that it drives greater specialisation in activities where a country or a firm has a comparative advantage. Access to markets and increased demand allows firms to benefit from economies of scale, generating larger volumes of activity without increasing the number of people employed or without increasing other inputs in the same proportion. Firms which are more heavily exposed to international competition have a stronger incentive to innovate and achieve efficiency improvements than businesses that operate exclusively in more sheltered domestic markets.

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<sup>149</sup> See McQuinn, K., and Whelan, K., Europe's Long-Term Growth Prospects: With and Without Structural Reforms, 2015; and IMF, The New Normal: A Sector-Level Perspective on Productivity Trends in Advanced Economies, 2015

The empirical evidence confirms the strong link between trade, productivity and growth. The European Commission estimates that a 1 per cent increase in the openness of the economy leads to an increase of 0.6 per cent in labour productivity<sup>150</sup>. The IMF notes that reductions in barriers to trade have been a driver of both output and productivity growth<sup>151</sup>.

While barriers to trade in advanced countries have been reduced substantially in recent decades, there is further scope to address remaining tariffs and other barriers to inward investment, which could produce additional improvements in productivity. The IMF estimates Ireland would be one of the biggest beneficiaries of reduced tariffs with a 7.7 per cent potential productivity gain from eliminating remaining tariff barriers. Historically, the removal of barriers to trade and enhanced access to new and existing markets has been an important driver of Irish economic development.

As well as substantial intra-EU trade, Ireland has significant trading links outside of the EU. Ireland's export destinations, however, are very concentrated and over a third of our goods exports go to just two countries (i.e. the US and UK). Multilateral trade agreements improve access to imports and facilitate access to export markets, with potential benefits arising for both enterprise and consumers.

The EU has exclusive competence in relation to the negotiation of trade agreements, and in this context Ireland needs to ensure that its interests are progressed in such negotiations. This is reflected in the *Programme for Partnership Government*, which notes that safeguarding Ireland's interests in the context of any future international trade negotiations is a key priority. A number of challenges and uncertainties lie ahead given the outcome of the UK Referendum on EU Membership, not least insofar as our trading relationships are concerned. Ireland must maximise the opportunities which arise from negotiated trade agreements. At the same time, Ireland's approach to the negotiation of trade agreements must acknowledge and address concerns of stakeholders.

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**Recommendation:** Ensure opportunities arising from EU negotiated trade agreements are availed of whilst simultaneously addressing the concerns of stakeholders

**Responsibility:** Government

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An open trade policy allows firms to fully benefit from international production networks. The ability to learn from firms with high levels of productivity is stronger in economies that are more connected with the global frontier via trade (i.e. those that are more integrated in GVCs). A key challenge for future productivity is how to best capitalise on the benefits of GVC participation.

Over 70 per cent of global trade is now in intermediate goods and services and in capital goods. The growth of GVCs has increased the interconnectedness of economies and has resulted in growing specialisation in specific activities and stages in value chains, rather than in entire industries. Participation in GVCs is, therefore, a critical component of a country's ability to increase productivity and compete internationally.

GVC participation may boost productivity via a number of channels, including stronger competitive pressures that reduce the cost of intermediate inputs and access to a wider variety of foreign inputs that embody more productive technology.

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<sup>150</sup> European Commission, Raising Productivity Growth: Key Messages from the European Competitiveness Report, 2007

<sup>151</sup> IMF, Reassessing the Productivity Gains from Trade Liberalization, IMF Working Paper, 2016



OECD data suggests that FDI in Ireland is largely responsible for Ireland's high participation rates in GVCs. Increasing exports from indigenous firms, and enhancing linkages across the FDI and indigenous enterprise sectors offers potential to deepen indigenous firms' links in GVCs. Inward investment brings many benefits such as jobs creation, increased tax revenue, enhanced competition and an expansion of trade. The international evidence on productivity spill overs from multinationals is however mixed. In an Irish context research has shown little strong evidence for productivity spill overs from FDI. Research indicates that to benefit from the presence of FDI, firms' absorptive capacity is particularly important (i.e. they must possess certain capabilities before they can usefully apply knowledge gained from a multinational)<sup>152</sup>. This suggests that policies which strengthen the absorptive capacity of indigenous firms are central to enhancing productivity levels through knowledge diffusion.

In addition to the reforms proposed elsewhere in this report (i.e. in relation to education and training, enhancing knowledge based capital, etc.) policies which encourage multinationals to generate linkages with the domestic economy and which provide new and potential investors with information on the availability sub-suppliers are important: these linkages between multinationals and indigenous SMEs are key channels to support productivity growth<sup>153</sup>. Policies that help to eliminate information and matching barriers, that enhance SMEs' capabilities to meet multinationals standards (e.g. for suppliers), and that provide tax incentives for multinationals to engage with indigenous SMEs can all facilitate productivity growth, allowing SMEs to capitalise on the infrastructure, pool of knowledge, innovation activities, and access to international markets of the multinationals.

The development of greater linkages between indigenous and foreign owned firms also offers Ireland a potential competitive advantage in terms of attracting FDI and developing Ireland's indigenous enterprise base. The Council welcomes the ongoing partnership of IDA Ireland with Enterprise Ireland and its indigenous base of companies in identifying synergies, enhancing clusters and participation in site visits. The Enterprise Ireland-IDA Ireland Global Sourcing initiative provides procurement teams in multinational companies (not only in Ireland but also internationally) with access to innovative Irish companies in all sectors.

Since its inception in 2012, the Action Plan for Jobs has aimed to increase the linkages between indigenous and multinational sectors. For example, APJ 2015 committed to further the implementation of the Global Sourcing initiative across Enterprise Ireland and IDA Ireland, and to increase global sourcing sales by EI client companies by €100 million over 3 years and by €30 million in 2015. To further strengthen the initiative, supplementary sectoral strategies have been developed and are being progressed by both Agencies. It is important that the effectiveness of this initiative is evaluated.

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**Recommendation:** Review the effectiveness of the Global Sourcing Initiative. Strengthen and intensify linkages between indigenous and multinational enterprises. This includes active engagement by the enterprise agencies to assist suitable indigenous companies to optimise supply chain business opportunities.

**Responsibility:** IDA Ireland, Enterprise Ireland, Department of Jobs, Enterprise and innovation

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<sup>152</sup> See OECD, *Interconnected Economies - Benefiting from Global Value Chains*, 2013; and Forfás, *Perspectives on Irish Productivity*, 2007

<sup>153</sup> IMF, *Ireland Country Report No. 16/257*, 2016

### Facilitating Start-ups and Scaling of Firms

In Ireland, small and medium sized enterprises account for 99.8 per cent of the total enterprise population and 69 per cent of total persons engaged. Developing a cadre of firms of sufficient scale and capability to make the productivity leap and succeed in international markets is integral to competitiveness.

As noted by the OECD, in most countries there is a divergent productivity performance at sectoral and national level between the most productive enterprises and the long tail of relatively poorly performing firms with low or no productivity growth. Across the OECD, firm size appears to matter in terms of productivity performance. Larger firms tend to be, on average, more productive than smaller ones, particularly in the manufacturing sector (partly reflecting gains from returns to scale, for instance through capital-intensive production). At the same time, there is evidence that a firm's rate of growth, job creation, and export activity is related more directly to the age of the business than to its size<sup>154</sup>.

Analysis of Irish total factor productivity (TFP) by the IMF shows that the TFP of the median large firm is not significantly different from the TFP of the median small and medium-sized firms, while the level of TFP of the top small firms is well above that of larger firms in both the manufacturing and services sectors<sup>155</sup>. The IMF research also suggests that younger firms have relatively lower TFP to begin with and, as experience is gained and production efficiencies are realised, TFP gains increase.

New firms are, therefore, especially relevant for expanding productivity and innovation performance. New start-ups, particularly in ICT, are more inclined to engage in more radical innovations which enhance productivity than incumbents who tend to adopt a more incremental approach. A continuous flow of new business start-ups that can survive and thrive in international markets strengthens the productivity base not only through the creation of new businesses, products and services but also by stimulating improved performance in existing businesses. More than half of productivity growth at the industry level has been attributed to new entrants. From a policy perspective, therefore, facilitating entrepreneurship, start-ups and firms of scale must be seen as the dynamo of productivity growth in the long run.

In Ireland, the number of active enterprises and business births remains below pre-crisis levels. CSO data shows there were approximately 238,000 active enterprises in the private business economy in Ireland in 2014, compared to over 244,000 in 2008<sup>156</sup>. The services sector accounted for 51 per cent of all enterprises in 2014 which is higher than the EU average (46.5%) but lower than the UK (57%) and six other Member States.

The data shows there were 16,257 new enterprise births in 2014, an increase of nearly 18 per cent on 2013; 85 per cent of enterprises created in 2013 were still active in 2014. Of the 17,843 enterprises birthed in 2009, 61 per cent survived to 2014. However, simply measuring the number of individual entrepreneurs or company incorporations is insufficient. Policies that fail to consider the quality of entrepreneurial activity are not likely to succeed. The 5 year survival rate also underlines the importance of policies which support start up activity being accompanied by complementary approaches which facilitate new firms surviving and scaling.

To be effective, investment by the State in entrepreneurs must be well targeted; avoid deadweight; and evaluate the potential quality of entrepreneurial activity, particularly potential to scale. State support for start-ups is critical. As part

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<sup>154</sup> IMF, Fiscal Monitor: Acting Now, Acting Together, 2016

<sup>155</sup> IMF, Ireland Country Report No. 16/257, 2016

<sup>156</sup> CSO, Business Demography, 2016

of Enterprise Ireland's offering in the start-up space, the agency looks to develop and target High Potential Start-ups (HPSUs)<sup>157</sup>.

An evaluation of HPSU supports found that the impact from the HPSU package of supports is very positive in terms of survival, sales, exports and employment, and suggests a strong causal link between performance and the injection of support<sup>158</sup>. In the immediate term, the evaluation found that higher numbers of HPSUs are likely to arise from spin outs from research. In this regard the commitment in Innovation 2020, to target an increase the numbers of HPSUs from spinouts by 45 per cent in the next four years, is welcome.

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**Recommendation:** Increase the numbers of HPSUs from spin out programmes in accordance with Innovation 2020.

**Responsibility:** Enterprise Ireland, Knowledge Transfer Ireland

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While no single policy intervention can be expected to generate critical impact on increasing start up levels, various coordinated interventions taken together can combine to create an environment that facilitates the creation of start-ups of scale. This requires institutional arrangements that facilitate efficient firm entry, growth, and exit. While demands on Government finances are intense, investment to stimulate and support enterprise development must be prioritised. In addition, improving the administrative and regulatory environment, and increasing the efficiency of public administration are cost-effective means to stimulate enterprise productivity.

Easing administrative burdens imposed through regulation can improve firm level productivity by reducing costs and minimising the time businesses spend fulfilling regulatory requirements. Well-developed capital markets for seed and early stage finance; bankruptcy laws that do not excessively penalise failure; and low entry barriers to entrepreneurship are fundamental for the development of innovative start-ups.

The World Bank's annual Doing Business report sheds light on how easy or difficult it is for a local entrepreneur to open and run a small to medium-size business when complying with a range of regulations<sup>159</sup>. In the most recent report, Ireland was ranked 18<sup>th</sup> out of 190 countries in terms of the ease of doing business. Ireland was ranked 5<sup>th</sup> in the euro area and 7<sup>th</sup> in the EU overall, behind Denmark, Finland, Sweden and Germany.

Ireland's ranking is not just a question of Ireland's performance across the range of regulations analysed; our ranking also reflects the performance of other countries and the reforms these countries are making to improve their performance relative to Ireland. It is also acknowledged that economies at the upper end of the rankings find it more difficult to improve their performance vis-à-vis competitors and to achieve a significant impact through incremental reforms, due to their already strong performance (i.e. as a country nears the frontier or limit of best practice, it becomes more challenging to achieve reform).

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**Recommendation:** Continue to monitor Ireland's performance in relation to entrepreneurship and administrative burdens. Actively pursue reform in areas of identified weakness.

**Responsibility:** Department of Jobs, Enterprise and Innovation

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<sup>157</sup> HPSUs are start-up businesses with the potential to develop an innovative product or service for sale on international markets and the potential to create 10 jobs and €1m in sales within 3 to 4 years of starting up.

<sup>158</sup> Forfás, Evaluation of Enterprise Supports for Start Ups and Entrepreneurship, 2014

<sup>159</sup> Doing Business measures and tracks changes in regulations (and their quality) affecting key areas in the life cycle of a business: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts, resolving insolvency and labour market regulation.

### Enhancing Productivity Performance at Firm Level

While aggregate productivity levels remain subdued, the OECD has found that those firms that can combine technological change, organisational and process innovation continue to experience growth. There are many benefits for firms undertaking innovation including greater responsiveness and understanding of customer demands; faster turnaround times; reduced waste; cost improvements; and efficiencies arising from organisational improvements in product design and quality.

At firm level, more intensive innovative activity is associated with higher productivity growth. Economy-wide productivity and employment gains are generated when innovations are diffused and widely adopted, making the strengthening of technology diffusion mechanisms a key policy priority. As noted by the OECD, synergic investments in R&D, skills, organisational know-how (i.e. managerial quality) and other forms of knowledge-based capital enable economies to absorb, adapt and reap the full benefits of new technologies<sup>160</sup>.

The Community Innovation Survey has previously highlighted that the biggest factors hampering the level of innovation activity – and thus productivity growth - in Ireland were access to finance and costs of innovation. This held for both innovative and non-innovative enterprises. Access to finance is considered in greater detail in Chapter 4, while actions to enhance the environment for innovation are considered in detail in Chapter 7. The focus here is on the role of the State in enhancing incentives for investment in productivity enhancing techniques at firm level.

From a productivity perspective, increasing participation on programmes based on Lean principles appears to be an important means of increasing innovative activity and productivity<sup>161</sup>. Enterprise Ireland provides supports for companies to enhance productivity, improve competitiveness and realise transformational change based primarily on Lean principles. EI supports three lean programmes targeted at companies at different stages in the Lean adoption process, focused on improving the capacity and capability of people and processes.

Evaluation analysis of the Lean programme has found that participating firms enjoy considerable productivity gains as a result. Econometric analysis shows that Lean delivered positive benefits to participating companies in terms of sales, employment and value added per employee: 77 per cent of participants reported improvements in productivity and/or capacity increases in their final project reports. Lean client companies had an annual productivity performance that was approximately €37,000 per employee higher than companies in the control group. This analysis excludes capacity increases that have yet to impact on sales and future assessments of Lean may show a more pronounced effect on productivity performance.

The devaluation of sterling following the UK vote to leave the EU has negatively impacted on the competitiveness of Irish exporters, particularly in a number of sectors with significant exposure to the UK. In the context of Brexit, there is a requirement for an increased emphasis on the promotion of Lean and other competitiveness and R&D and innovation programmes to assist companies overcome the challenges posed by Brexit.

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**Recommendation:** Develop a strategy for increasing awareness of the benefits of participation in productivity enhancing programmes such as Lean.

**Responsibility:** Enterprise Ireland

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<sup>160</sup> OECD, The Future of Productivity, 2015

<sup>161</sup> The application of Lean principles is designed to build enterprise capability and capacity in people and processes. The core idea is to maximize customer value while minimizing waste. Simply, lean means creating more value for customers with fewer resources. See <http://www.lean.org/WhatsLean/>

**Recommendation:** Identify specific areas for a step change in productivity, including assessment of the return on investment from innovation at firm level.

**Responsibility:** Enterprise Ireland

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The speed and pervasiveness of technology diffusion, absorption and use throughout the economy is an important driver of productivity. OECD research suggests that frontier technologies are not immediately adopted by all firms. Instead, they are first adopted by national frontier firms, and only diffuse to laggards once they are tested by the leaders and adapted to country specific circumstances. As a technologically advanced economy, domestic innovation (as opposed to imitation) assumes greater importance for Ireland.

**Recommendation:** Build upon the Review of Enterprise Supports for Research, Development and Innovation, which is currently being undertaken by DJEI, to ensure that the needs of all companies engaging in research and innovation are being met. Particular focus should be directed to supports designed to maximise industry-HEI linkages.

**Responsibility:** Department of Jobs, Enterprise and innovation, Enterprise Agencies

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Management skills at leadership level and a strong middle management layer are an essential element in driving improved productivity performance. Recent assessments of management skills in Ireland present some cause for concern: according to the IMD Executive Opinion Survey, the perceived ability of Irish companies to adapt to market change has declined, and Ireland's ranking fell from 3<sup>rd</sup> in 2014 to 14<sup>th</sup> in 2015; our ranking in terms of the effectiveness of corporate boards has fallen from 9<sup>th</sup> to 24<sup>th</sup>; and our ranking in relation to the entrepreneurship of managers has declined from 11<sup>th</sup> to 24<sup>th</sup> over the same period.

The Council endorses the Enterprise 2025 ambition of delivering a demonstrable uplift in business leadership skills to drive innovation and internationalisation across a broader cohort of enterprises, and in management capability across the enterprise base, so that all firms have the potential to achieve a one-step-up to higher business performance and growth.

Highly proficient leadership, with ambition, vision and strong management teams, is critical for establishing the environment that facilitates an innovative culture. Research into management practices across firms and countries suggests that variations in management practices are an important factor accounting for differences in productivity. From a policy perspective, a number of areas are relevant to enhancing management quality.

Firstly, competitive markets are important in that well managed firms gain greater market share as poorly managed (and less productive) firms exit the market. Secondly, the quality of management education and multinational presence are valuable in improving management practices.

At a global level, the available research shows that there is a strong relationship between management practice and business performance<sup>162</sup>. The OECD has found a positive relationship between management development, management practice and the bottom line performance of a firm. Management capability has a direct impact on the innovation performance of firms also. For example, in the manufacturing sector, managerial quality differs significantly between countries and Ireland scores relatively poorly, particularly when compared to the US, Japan and

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<sup>162</sup> Bloom, N. et al, Management Practices Across Firms and Countries, National Bureau of Economic Research, 2012

Germany. Increasing managerial quality in manufacturing in Ireland to the best practice levels observed in the US could boost potentially boost manufacturing productivity by over ten per cent<sup>163</sup>.

Enterprises that have engaged in management development and/or mentoring programmes tend to outperform those that have not. There are already many successful management development programmes – for example Enterprise Ireland runs a range of mentoring programmes, including Leadership 4 Growth, Innovation 4 Growth, Lean and transformational change programmes. Client companies that participate in these programmes exhibit stronger employment growth than companies that do not participate. Skillnets, through Management Works offers a successful suite of subsidised management development programmes to help business owners, managers and management teams achieve better results.

There is an urgent need to broaden the reach of programmes catering to management development. Not all of the elements of existing programmes, however, are relevant to all of the firms currently not engaging in management development. For many locally trading firms in the hospitality, retail or construction sectors for example, programmes designed to boost the management capability of an exporting firm may not be directly applicable. Such firms may benefit more from greater exposure to mentoring, and/or peer-to-peer networking, and to modules related to managing sales/revenue growth. A broad range of options are available for enterprises - from more intense leadership programmes, to light touch mentor services and/or peer-to-peer networks that can assist the CEO and owner/manager at every stage of the company lifecycle.

There is a need to increase the take up of management development amongst firms. There is also a need to identify the elements of existing management development programmes that can be tailored to meet the needs of different cohorts of firms. Thereafter, mechanisms to increase engagement with firms (particularly locally trading SMEs) that do not currently participate in management development are required to disseminate relevant modules. Private companies already pay for management development without recourse to the State and the Council believes this pattern should continue. However, from a policy perspective, there remains a need to work with enterprise and to maximise existing supports to enhance management capability across the entire enterprise base.

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**Recommendation:** Increase awareness about and take up of management development initiatives by enterprise. Develop mechanisms to facilitate the tailoring and extension of relevant programme modules to cohorts of firms currently not engaging in such programmes.

**Responsibility:** Local Enterprise Offices, Skillnets, Enterprise Ireland

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### Irish Productivity Data

Measures of productivity levels and growth are important barometers of the competitiveness of firms, sectors and economies. However, accurately measuring productivity performance is complex. The Total Economy Database, the OECD and Eurostat all provide estimates of annual productivity performance. However, there are differences between these international datasets in terms of coverage and measurement. Other methodological differences (e.g. the choice of base year used, the currency in which data is expressed) as well as the impact of the FDI sector on Irish data makes international comparison of performance difficult. Data also tends to be volatile.

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<sup>163</sup> OECD, Knowledge Based Capital, Innovation and Resource Allocation, 2013

## Ireland's Competitiveness Challenge 2016

In the Competitiveness Challenge 2015, the Council recommended that the potential to develop and publish a comprehensive national productivity dataset should be explored by the CSO. Such an exercise would be similar to work undertaken by the Office of National Statistics in the UK and would aim to produce measures of labour, capital and total factor productivity, at a national and sectoral level. The Department of Finance, the Department of Jobs, Enterprise and Innovation and the Central Statistics Office have begun work to develop such a dataset.

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**Recommendation:** Develop detailed metrics to measure productivity performance at sectoral level.

**Responsibility:** CSO, Department of Finance, Department of Jobs, Enterprise and Innovation

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### Public Sector Productivity

The efficiency and effectiveness of public service institutions is a major driver of our overall national competitiveness. The Council recognises the significant contribution made by the public service in supporting Ireland's return to economic and employment growth in recent years. A range of major reforms in ICT, procurement and shared services have already been delivered through the Public Service Reform Plan. These reforms have helped to maintain and improve delivery of public services at a time of increasing demands for public services. The Council also recognises that these reforms have been undertaken against a backdrop of reduced resources, recruitment restrictions and pay constraints.

The public service must continue to be ambitious in driving reform and delivering improved services for citizens. The momentum of reform must be maintained and it is important that considerations about public sector pay are informed by productivity considerations. Efforts to assess and measure improvements in public sector productivity levels and services should form an important element of the ongoing renewal of our public services. Given the nature, diversity and complexity of the public sector, assessing public sector productivity levels and growth rates is challenging. However, measurement is vital - not only because the public sector is the largest sector in the economy, but also because of the importance of the services it provides to citizens and the enterprise sector.

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**Recommendation:** Develop metrics for public sector productivity levels and services.

**Responsibility:** Department of Public Expenditure and Reform

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## Chapter 7: Broadening the Enterprise and Export Base

### Why Enterprise and Exports Matter for Competitiveness

Sustainable growth (and the job creation it brings) is reliant on the ability of Irish enterprises to trade internationally and maintain export competitiveness. Exporting fuels the domestic economy and delivers more sustainable job opportunities than could otherwise be achieved by an economic model dependent on consumption or government expenditure. Trade and investment improves competitiveness through two channels: first, by increasing the size of the market available to domestic firms; and second, by driving productivity and innovation by exposing firms to international competition, expertise, and technology.

While the trade performance of an economy such as Ireland's will always be conditional on the ebb and flow of global markets, a more diverse export base can reduce exposure to external demand shocks, exchange rate fluctuations, instability in export earnings, upgrade value-added, and enhance growth and jobs. Irish based exporters must scale and diversify sustainably and strategically to reduce exposure to external economic shocks. To increase competitiveness, economic growth and sustainable jobs, we need a strong and dynamic range of FDI, Irish owned businesses that export, an increased level of start-ups (particularly those with the potential to scale and internationalise) supported by an administrative and regulatory framework that facilitates enterprise and exports. There is a need to evolve into new products, markets and sectors, whilst maintaining the competitive advantages we enjoy in existing ones. Innovation is key to enterprise and export competitiveness in the long run. We must ensure that Irish enterprise stays at the forefront of technology and innovative activity, and support the development of clusters.

### Current Context

There have been many national strategies devised over the past number of years to aid export growth and assist exporters. Some notable strategies referenced in the subsequent text include:

- Successor to EI's *Driving Enterprise – Delivering Jobs Strategy to 2016* (due to be published in early 2017);
- Action Plan for Jobs (published yearly from 2012 to 2016);
- Enterprise 2025 (published in 2015);
- Innovation 2020 (published in 2015);
- IDA's *Winning: Foreign Direct Investment 2015-19* (published in 2015);
- National Policy Statement on Entrepreneurship (published in 2014); and
- Trading and Investing in a Smart Economy – A Strategy and Action Plan for Irish Trade, Tourism and Investment to 2015 (published in 2010).

These strategies combined have ensured that export growth was particularly robust over the past number of years driven by the activities of the multinational sector, with year-on-year growth of nearly 14 per cent recorded in 2015, and increased export intensity of indigenous companies. Two notable features of this robust performance are evident: our export figures have become more volatile, owing to many of the factors that distort national accounts data (see



Chapter 2) and concentrated towards the services sector<sup>164</sup>. Services now account for approximately half of total Irish exports, and the shift to services has been more rapid in Ireland than for global services trade as a whole. Globally, the services sector contributed just over 40 per cent of the value added in goods exports in 2009. In Ireland this figure was over 60 per cent<sup>165</sup>. Global services trade appears to be more resilient than goods trade and over time, the share of services trade should continue to increase, especially in sectors related to information technologies and data transfer<sup>166</sup>. Ireland is well positioned to capitalise on the resilience of the robust trade volumes of global services.

The strong positive export performance recorded in 2015 is likely to persist and support continued robust growth over the forecast horizon. However, as set out in Chapter 9, the decision by the UK to leave the EU creates a challenging environment for some exporters. There are signs emerging that the global slowdown in trade is impacting, and will to continue to impact upon, Ireland. There is a great deal of uncertainty around future drivers and prospects for export growth. Byrne and Brien (2015) argue that the response of Irish exports to rising global demand may be lower in the coming years than had previously been the case.

Following years of weak performance, global merchandise trade growth reached a post-crisis low in 2015 according to the World Bank, largely reflecting a marked deceleration in import demand from commodity exporters and slowing activity and economic rebalancing in China. Many of the factors underpinning the recent slowdown are expected to continue unabated. Growth forecasts for key export markets and headline global trade for 2016 and beyond have, in general, been revised downwards. Emerging market and developing economies (EMDEs) are facing weaker growth and the recovery in major advanced economies has stalled. Further commodity price declines have worsened the prospects for commodity exporting EMDEs. Furthermore, indigenous exporting sectors have benefitted from a relatively competitive exchange rate, although the recent depreciation of sterling provides a less supportive environment for some in the near-term. Ireland has a very high degree of participation in Global Value Chains (GVCs), with just over 40 per cent of our exports in 2009 utilising contributions from foreign industries. GVC growth is forecast to be at a slower pace as a result of the shortening of global supply chains towards regional ones. This could also have significant negative ramifications for Ireland's export performance.

### How Ireland Performs

This section is based on the Council's findings contained in Ireland's Competitiveness Scorecard 2016, published earlier in 2016.

While exports have been the primary engine of economic growth in Ireland in recent years, the composition and range of goods exported from Ireland has become increasingly concentrated. Ireland's Competitiveness Scorecard 2016 shows that Ireland has increased its share of the world's services market, reaching 2.7 per cent in 2014, up from 2.2 per cent in 2005. Over the same period, Ireland's share of global merchandise exports declined from 1 per cent to 0.7 per cent in 2015. Ireland's share of total global export markets is 1.1 per cent, as of 2014. Ireland lost market share in pharmaceuticals, insurance and financial services between 2009 and 2014. On the other hand, strong gains were recorded in the telecommunications and information services sector. Overall our top services exports emanate from the computer and business services sectors, whilst chemicals (and particularly medical and pharmaceutical products) are the primary goods exports.

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<sup>164</sup> Services exports grew by a very strong 10 per cent, with exports of aircraft leasing and ICT services posting notable growth rates.

<sup>165</sup> Byrne, S. and O'Brien, M., *The Changing Nature of Irish Exports: Context, Causes and Consequences*, Central Bank of Ireland, 2015

<sup>166</sup> World Bank, *Global Economic Prospects Divergences and Risks*, June 2016

The World Bank recently announced Brazil, Russia, India and China (BRICs) accounted for about 40 per cent of global growth from 2010 to 2015<sup>167</sup>. While the value of Irish exports to BRICs increased in value terms over the corresponding period, only a minor increase was recorded in terms of exports as a proportion of GDP between 2010 and 2014.

Ireland is the leading EU performer when it comes to SME internationalisation, with over 31 per cent of Irish SMEs exporting beyond EU borders, compared with the EU average of 10.7 per cent. Although the costs required to import and export are slightly higher than in the rest of the EU, the time and number of formalities required to trade with the rest of the world are well below the EU average. Trading activities of Irish SMEs within the single market are also above the EU average, due in part to a significant reduction in the procedures and time to trade.

### Policy Challenges and Recommendations

The Council welcomes the publication of Enterprise 2025 (EP2025) in late 2015. The Strategy recognises that sustainable long term growth is dependent on continued success in international markets and aims to:

- Grow the exports of Irish owned firms by 6-8 per cent per annum to 2020;
- Broaden the geographic market focus of the Irish owned enterprise base beyond UK markets to reach exports of between €5 and €6 billion by 2020;
- Further diversify Ireland's export markets to the Eurozone and high growth markets;
- Increase the number of Irish owned firms that export to more than one country;
- Increase the export intensity of the indigenous firms to between 55 and 60 per cent from just over 50 per cent currently; and
- Further diversify the sectoral profile of exports overall.

Among its targets, the Strategy commits to a step change in the performance of our enterprises across the economy – with more Irish owned companies of scale, a greater number of start-ups with better survival rates, more entities investing more in research, development and innovation, more enterprises exporting across a range of markets – delivering quality jobs and sustainable growth. This will require a tailoring of interventions to meet the specific needs of enterprise, with the objective of delivering growth in exports and employment.

### Internationalisation and Market Diversification

Trading and Investing in a Smart Economy – A Strategy and Action Plan for Irish Trade, Tourism and Investment to 2015 was published in 2010. This Strategy identified a number of high-level targets for growth in exports, investment, tourism and jobs to 2015 and set out a 25-point Action Plan for achieving these targets<sup>168</sup>. Following the launch of the Strategy, a list of 27 priority export markets was identified and Local Market Teams were established in each priority market<sup>169</sup>.

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<sup>167</sup> World Bank, Global Economic Prospects Divergences and Risks, June 2016

<sup>168</sup> In addition, the Strategy included an analysis of global trends; sectors in which there were potential opportunities for Ireland in trade and investment; mature and high growth markets and potential opportunities for Ireland in some of these markets.

<sup>169</sup> Each Local Market Team is comprised of Embassy and Enterprise Agency staff and is responsible for drawing up annual Local Market Plans, ensuring that there is a coordinated approach in priority markets. The implementation of these plans and the overall progress of the Strategy are overseen by the Export Trade Council.

## Ireland's Competitiveness Challenge 2016

The Export Trade Council was established to oversee and monitor the implementation of the Strategy by providing a framework for coordination and consultation by Departments and State agencies as well as private sector representatives. The Government in January 2013 initiated a short, focused review of the Strategy.

Following the Review it was concluded that existing targets would be maintained and greater emphasis would be placed on sectors of competitive advantage as identified in the Action Plan for Jobs process. The Review also concluded there was a need for an evolution of the concept of 27 priority markets towards a new market approach which aimed to provide a more strategic, up-to-date and nuanced direction for Ireland's international trade, tourism, investment and education promotion efforts. The individual markets were disaggregated into those perceived as 'High Value Markets' - markets that can continue to deliver in the short-term and for the foreseeable future; 'Other Established and Developing Markets' – those with a more medium-term focus; and 'Exploratory and High Potential Markets' – those that may deliver in the long-term. The Export Trade Council maintained its responsibility for the Strategy's implementation and the modifications encompassed by the review.

With the expiration of the Strategy last year, APJ 2016 commits the Government to finalise a successor to the Trade, Tourism and Investment Strategy 2010-2015 by end Q4 2016. The Council view this publication as critically important in assisting the delivery the Government's targets and ambitions as set out in Enterprise 2025.

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**Recommendation:** Publish a successor to the *Trading and Investing in a Smart Economy – A Strategy and Action Plan for Irish Trade, Tourism and Investment to 2015* to assist the further internationalisation of Irish exporters, increase market diversification, and support investment. An increased focus on sectors of competitive advantage as identified in the Action Plan for Jobs process is required and their alignment with specific target markets.

**Responsibility:** Department of Foreign Affairs & Trade, Department of Jobs, Enterprise & Innovation, Department of Agriculture, Food & Marine, Department of Transport, Tourism and Sport, Department of Education & Skills, State Agencies

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**Recommendation:** Devise a clear implementation plan for the successor to *Trading and Investing in a Smart Economy – A Strategy and Action Plan for Irish Trade, Tourism and Investment to 2015* with specific timelines and assigned responsibility

**Responsibility:** Department of Foreign Affairs & Trade, Department of Jobs, Enterprise & Innovation, Department of Agriculture, Food & Marine, Department of Transport, Tourism and Sport, Department of Education & Skills, State Agencies

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### Indigenous Exporting Base

Enterprise Ireland's *Strategy to 2016* outlined a plan to support the creation of a further 40,000 new jobs in Irish companies by 2016. To deliver this, Enterprise Ireland provided supports both for companies and for researchers in Higher Education Institutes to develop new technologies and processes that lead to job creation and increased exports. Tangible evidence of commercial impact is the defining criterion underpinning the RDI instruments deployed by Enterprise Ireland. For example, commercialisation and technology transfer supports are directed at generating spinout companies and licensing into industry. Innovation-active companies provide high-quality employment and generate exports and tax receipts. RDI performers are gaining an increasing share of overall sales and export sales, and are accounting for increasing shares of employment.

Enterprise Ireland's *Driving Enterprise - Delivering Jobs Strategy to 2016* commits to providing direct supports to assist companies with internationalisation plans, including access to the supports provided by Enterprise Ireland's international Network of overseas offices, International Trade Missions, Sales and Marketing Review tools and financial supports such as the Market Access Grant and the Business Links programme. Enterprise Ireland provides

both financial and non-financial supports for the internationalisation of SMEs<sup>170</sup>. The importance of expanding our export base has been outlined above and EI will continue to play a key role in efforts to achieve a more diversified export portfolio.

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**Recommendation:** Continue to ensure an uplift in the number of market-ready firms internationalising and continue to work with targeted client companies to increase their internationalising capabilities.

**Responsibility:** Enterprise Ireland

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Supporting entrepreneurship is the key to increasing competitiveness and employment. It is estimated that 67 per cent of all new job-creation comes from businesses in the first five years of existence. SMEs account for 99.8 per cent of active enterprises in Ireland, 68 per cent of persons engaged, 50.3 per cent of turnover and 46.2 per cent of gross value added (GVA). Some 91 per cent of enterprises in the Irish business economy are micro-enterprises. Micro and small firms are involved in a broad spectrum of sectors and activities; including: software, medical technologies, food production, digital content, tourism, retail and wholesale, business, professional and personal services – many of which while low in terms of export and value added components are strong generators of employment.

In Ireland, and across the euro area, the number of new company formations remains below pre-crisis levels. Yet, simply measuring the number of individual entrepreneurs is insufficient. Policies that fail to consider the quality of entrepreneurial activity are not likely to succeed. To be effective, investment by the State in entrepreneurs must continue to be well targeted, avoid deadweight loss and evaluate the potential quality of entrepreneurial activity, particularly potential to scale and export. While no single policy intervention can be expected to generate critical impact on increasing entrepreneurship levels, various coordinated interventions taken together can combine to create an environment that facilitates the creation of start-ups of scale.

The Council welcomes a number of recent actions to boost entrepreneurship such as the establishment of monitoring committees for Regional Action Plans and tax reforms announced as part of Budget 2016 which are designed to facilitate start-ups. The Council also welcomes the commitments contained in APJ 2016 to support 185 high potential and early stage start-ups and launch ten competitive start funds to support 100 entrepreneurs, including two funds targeted at attracting overseas start-ups to Ireland.

The 2014 National Policy Statement on Entrepreneurship is a particularly welcome step as it sets out the Government's holistic approach to improving the Irish entrepreneurship ecosystem. To meet the Statement's objectives, the barriers to achieving a 25 per cent uplift in the number of start-ups, and increasing the survival rate of start-ups should be addressed as a matter of urgency. These include leadership capabilities, strategic focus, access to skills and access to finance.

Benchmarking the framework conditions that support enterprise formation and the level of entrepreneurship in a country is a complex task as there are many variables involved. Internationally comparable data on enterprise formation and the factors which affect the entrepreneurship ecosystem is collated by a wide variety of sources. These include the World Bank, GEM, GEDI and the OECD. However, at present there is little data available on the employment, scaling and survival performance of Irish enterprise, particularly start-ups relative to our international

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<sup>170</sup> For example, Enterprise Ireland's overseas structure through its own overseas office network and its extended Pathfinder (trade consultant) network provides clients with the appropriate support in markets where there are identified opportunities matched by client capability and client interest / demand. In addition, Enterprise Ireland provides financial supports such as the Internationalisation Grant, Going Global Grant, New Geographic Market Research Grant and Graduates for International Growth.

## Ireland's Competitiveness Challenge 2016

competitors. More timely and granular data that is internationally comparable would facilitate more effective policy evaluation on the key enabling components for entrepreneurship, survival and scaling. The Department of Jobs, Enterprise and Innovation in the context of the National Policy Statement on Entrepreneurship should consider engaging with the CSO, Companies Registration Office and Enterprise Ireland regarding the development of business demography indicators which monitor the level of quality of enterprise formation, scaling and survival and which are robust and can be measured over time.

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**Recommendation:** Address the immediate policy obstacles to achieving the objectives of the National Policy Statement on Entrepreneurship.

**Responsibility:** Department of Jobs, Enterprise and Innovation, Enterprise Ireland

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Local Enterprise Office's (LEOs) promote entrepreneurship, foster business start-ups and develop existing micro and small businesses to drive job creation and to provide accessible high quality supports for people interested in starting up a new business or already in business including; entrepreneurs, early stage promoters, start-ups and small business looking to expand. APJ 2016 commits the Government to publish an ambitious medium term strategy for LEOs to achieve a step-up in small business performance by the end of 2016. The Council view this as a pre-requisite to achieving the aforementioned targets in the National Policy Statement on Entrepreneurship.

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**Recommendation:** Publish an ambitious medium term strategy for the Local Enterprise Offices to achieve a step-up in small business performance as committed to in APJ 2016.

**Responsibility:** Department of Jobs, Enterprise and Innovation

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Analysis of Enterprise Ireland's client base indicates a shift underway in the number and proportion of companies scaling over the period 2010-2013. There has been a 35 per cent relative increase in the number of firms at turnover levels of €10m to €20m. In addition, the number of firms at the €20m-€50m turnover band has increased by 22 per cent. Overall, the numbers of firms at the bands of €10m-€20m, €20m-€50m and greater than €50m are at historic highs over a 10 year period. The analysis indicates that there are challenges in bringing companies to the initial point at which they have good scaling potential at around €5m (or €10m for Food companies). As set out above, there are particular challenges in relation to building scale and interventions that may require a variety of different supports at appropriate stages of development. Policy must continue to assist indigenous firms to grow to scale and capture new market opportunities, which will increase their contribution to growth and exports.

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**Recommendation:** Address the main obstacles in relation to building scale to facilitate an up-lift in the scaling and sustainability of new enterprises.

**Responsibility:** Department of Jobs, Enterprise and Innovation, Enterprise Ireland

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### Deepening and Broadening the FDI Base

Despite increasing competition and changing FDI composition, Ireland remains highly competitive as a location for new and existing FDI. The challenge of sustaining investments from established investors, while at the same time diversifying Ireland's FDI portfolio by tapping into new and emerging growth opportunities, is well recognised by IDA Ireland in its new strategy statement.

As a small, peripheral, island economy, it is critical that Ireland's firm level offerings and suite of tax offerings for FDI remains competitive and best in class. Despite intense international competition for globally mobile investment, the Irish corporation tax regime remains competitive and stable. However, the gap between Ireland and OECD countries is narrowing. While Ireland's corporate rate has remained consistent over time, many countries have reduced their rates, notably the UK, Japan and Finland. As set out in the Scorecard, many countries also have separate corporate rates for small businesses. Further, effective rates are often significantly lower than headline rates.

The Department of Finance's Road Map for Ireland's Tax Competitiveness outlines a comprehensive package of competitive tax measures which provides the basis for Ireland to remain competitive for FDI. Implementation of the actions set out in the road map must be continued. Long term certainty, transparency and predictability with regard to the corporate tax regime is critical in informing the long term investment plans of inward investors in Ireland. The confirmation in Budget 2017 of continued certainty around the maintenance of the 12.5 per cent corporation tax rate on trading income is welcome.

As the international tax environment is changing rapidly, maintaining a good reputation has become increasingly important for the sustainability of corporation tax policy here in Ireland. When making investment decisions MNCs take into account the integrity of a country's taxation system. Therefore, protecting and maintaining Ireland's reputation in relation to Corporation Tax is of paramount importance given the importance of FDI to the country. The Council welcomes Ireland's active engagement in the OECD Base Erosion and Profit Shifting ('BEPS') project and other measures in line with the International Tax Strategy published last year to protect our reputation. Ireland will be

- An early adopter of Automatic Exchange of Tax Information;
- Supportive of OECD proposals for Country by Country reporting; and
- One of the first countries worldwide to carry out a Spillover Analysis of the impact of its tax system on developing economies<sup>171</sup>.

The introduction of a new "best in class" knowledge development box (KDB) and a broadening of the R&D tax credit is designed to improve Ireland's FDI tax offering and facilitate investment in R&D by Irish based enterprises. This new measure will provide a 6.25 per cent rate of corporation tax to apply to the profits arising from certain patented inventions and copyrighted software, resulting from qualifying R&D activity carried out in Ireland.

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**Recommendation:** Continue to develop our suite of tax offerings, which include the 12.5 per cent rate, the Knowledge Development Box, and the R&D Tax Credit, to ensure it is internationally competitive for enterprise and attuned to evolving sectors and activities in the context of continued engagement with the OECD's BEPS project.

**Responsibility:** Department of Finance, Tax Strategy Group

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While cost competitiveness, tax, and firm level financial supports remain core offerings clear trends have emerged as regards the factors which determine competitiveness for FDI. These include the optimisation of regions of scale, particularly urban centres, adequacy and availability of talent, international connectivity, R&D capabilities and sub-supplier and services infrastructure. The Council notes the continuing relevance of the IDA's 2015 Strategy Statement 'Winning' which also emphasises repositioning Ireland's offering in terms of Talent, Quality of Place, Connected World

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<sup>171</sup> Tax Strategy Group, Corporation Tax, TSG 15/01

Leading Research and Competitive Clusters. The increased emphasis on bringing first time investors to Ireland from new markets, particularly Asia Pacific, is also an important development.

Ireland has over many decades developed a national competence in FDI and IDA Ireland has become a world leader in attracting inward investment. New and established multinationals continue to invest and re-invest in Ireland in a number of established locations with leading global companies in Life Sciences, ICT, Engineering, Services, Digital Media, and Consumer Brands. A key challenge is to ensure that Ireland becomes a global leader in a finite number of areas. We must continue to build on our strengths in sectors and activities that are contributing to the economy through Greenfield investments, reinvestments and transformation of the existing base as well as scan the horizon for new opportunities. In terms of new investment opportunities it is vital that IDA Ireland actively examines the potential of new sectors to widen the flow of investment into Ireland as the FDI sector changes, expands and develops over the medium term.

In recent years, the global market for FDI has undergone significant changes, with emerging market multinational enterprises increasingly important. While the North American and European markets continue to be vitally important to Ireland from an FDI perspective, growth markets in Brazil, Russia, India and China (BRIC countries) and Asia Pacific in particular have become central sources of and destinations for global FDI flows. The Council welcomes the IDA's increased focus on these important markets.

IDA has put additional resources into these markets over the past five years and the results are encouraging with 'New Name' investments rising from 4 per cent in 2010 to 20 per cent in 2014 and on average accounting for 10 per cent of total investment. The Council welcomes the focus on developing markets beyond Ireland's traditional trading partners including doubling the number of trade missions, and placing extra staff in overseas markets. Consistent, sustained in-market presence by the IDA is needed to take advantage of emerging growth opportunities.

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**Recommendation:** Further diversify Ireland's FDI portfolio, tapping into sectoral opportunities arising from high-growth, emerging and exploratory markets based on the IDA's Strategy and on Enterprise Ireland's strategy, in the case of FDI in the food sector. Exploit the potential for future FDI opportunities in sectors such as: Marine Economy, Investments linked to Infrastructure, Property FDI, Arts and Culture and Energy Services.

**Responsibility:** IDA Ireland, Enterprise Ireland

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Enterprise Ireland client exports were €20.6bn in 2015, an increase of 10 per cent on 2014. Enterprise Ireland is forecasting to achieve its strategic export target of €22bn in 2016. Exports to the UK were €7.5bn - the second fastest growing market at 12 per cent. Exports to the UK as a proportion of Enterprise Ireland's total client exports declined from 45 per cent in 2005 to 37 per cent in 2015. This is a result of more companies diversifying their export strategies into Northern Europe, the USA and high growth markets including China, India, the Gulf and Brazil. Food exports to the UK as a percentage of total food exports have remained relatively static at around 40 per cent over the same period.

Supporting clients to diversify their exports while growing exports in the UK has been a central pillar of Enterprise Ireland strategy for over a decade. The UK will remain a priority market for Irish exporters. The job creation of Enterprise Ireland client's impacts country wide with 64 per cent of net jobs created in 2015 being outside Dublin. The total client expenditure in the Irish economy across payroll, goods and services purchased, was €23.7bn in 2015. Following the UK vote to leave the EU, Enterprise Ireland is developing a strategy for the period 2017-2020 which will have the twin focus of supporting clients to sustain the success that has been achieved to date in what will be a period of uncertainty while growing exports and employment. The strategy will focus on driving scale through competitiveness, innovation and expanding the reach of Irish companies

### Supporting Innovation

A strong innovative and internationally competitive enterprise base results in increased employment, sales and exports. For indigenous firms, innovation is at the heart of gaining competitive advantage and is central to their ability to compete and succeed in international markets.

Innovation-active enterprises are defined as those that have carried out a product, process, organisational or marketing innovation or that exercise an intellectual property right. Results from the Community Innovation Survey (CIS) 2012-2014 show that innovation activity rates for enterprises based in Ireland increased from 59 per cent to 61 per cent in the period 2012-2014<sup>172</sup>. While the increase is relatively small, in a European context Ireland continues to perform strongly and has the 3<sup>rd</sup> highest innovation rate of all countries for whom data has been published. The detailed findings from the CIS show:

- Significant variation in the level of innovative activity carried out by indigenous and foreign owned enterprises, and between and within sectors;
- Total expenditure on innovation activities in Irish industry and selected services sectors was almost €3.8bn in 2014, a 4 per cent increase in two years with in-house R&D accounting for 50 per cent of all expenditure<sup>173</sup>;
- Foreign owned enterprises, while only accounting for only 18 per cent of overall enterprises, they account for 61 per cent of all innovation-related expenditure, including €1.3bn on in-house R&D;
- Innovation expenditure in Ireland is dependent on an extremely narrow base of enterprises;
- The most frequent type of innovation activity undertaken was product or process (49%) followed by organisational (44%) and marketing innovation (40%). Over the 2012-2014 period, 38 per cent of enterprises carried out process innovation, while 36 per cent were engaged in product innovation; 27 per cent of enterprises engaged in both; and
- From a sectoral perspective, 45 per cent of industry enterprises were engaged in process innovation compared to 34 per cent of enterprises in selected services.

While Irish SMEs introduce more product, process, marketing and organisational innovations than the EU average, evidence does not show major market benefits from such R&D investments. The percentage of sales of new-to-market or new-to-firm innovations is lower in Ireland than in the rest of the EU (9.3% versus 12.4%). Overall, according to the European Commission, R&D spill overs between SMEs and multinational corporations in Ireland are relatively limited. These, along with the findings of the CIS highlight the scope to increase innovation activity rates in Irish enterprise, particularly in indigenous SMEs and in the services sector.

SMEs throughout the world depend on public R&D support for their own innovation prospects. The OECD, in its Economic Review of Ireland 2015, noted that future innovation requires a stronger contribution by Ireland's domestic firms and suggested that Government can help strengthen the indigenous sector by rebalancing its innovation policies towards more direct forms of support. The current Infrastructure and Capital Investment plan in Ireland does not provide for significant increases in public R&D spending and Ireland's innovative performance may suffer further as a

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<sup>172</sup> Published as CSO, Innovation in Irish Enterprises, 2016

<sup>173</sup> In the survey, Industry refers to the Mining and quarrying, Manufacturing, Energy and Waste and Water services sectors. Selected Services refers to Wholesale trade, Transportation and Storage, ICT, Financial Services, Architectural and engineering activities; technical testing and analysis; scientific research and development; advertising and market research.



consequence. In addition, R&D expenditure by higher education institutions is relatively low internationally. Improving our performance in these two critical areas represents a significant challenge for Ireland.

The Council, therefore, welcomes the 2015 publication of Innovation 2020 and the associated commitments in the Action Plan for Jobs (e.g. Horizon 2020 funding into Ireland, new spin outs from the research system, numbers of HEI-industry collaborations, commercialisation of publicly funded research etc.). A key commitment in Innovation 2020 is to increase total investment in R&D in Ireland, led by the private sector, to 2.5 per cent of GNP. On current official projections, this would mean that over €5 billion will be invested per year in R&D by the private and public sectors by 2020. This will represent almost doubling current levels of investment (€2.9 billion in 2014). However, overall levels of investment in research and development in Ireland remain below the best performing countries: currently, in terms of public R&D as a percentage of GDP, Ireland ranks 22<sup>nd</sup> in the EU. Ireland's EU commitments in this area are unlikely to be achieved without prioritised and sustained investment.

From a competitiveness perspective, the returns from knowledge based capital (KBC) are a vital component in securing productivity growth, diversifying and broadening the enterprise and export base, growing foreign direct investment, and creating new competitive advantage in intellectual property and commercial products and services. In a European context Ireland is considered a strong Innovator<sup>174</sup>. In terms of the public role for supporting KBC, OECD research finds that the strongest evidence for private under-investment exists for R&D-related spending – suggesting a continued important role for public investment.

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**Recommendation:** As part of the Mid-Term Review of the Capital Plan, address the commitment in Innovation 2020 to increase R&D investment to 2.5 per cent of GNP by 2020, with two-thirds from the private sector and one third from public investment.

**Responsibility:** Department of Public Expenditure and Reform, All Government Research Departments

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The CIS shows that in Ireland of those firms undertaking innovative activity, 31 per cent engaged in some co-operative activity when developing their innovations - some with partners in Ireland and some with partners outside of Ireland. The CIS results indicate there is potential to further increase levels of collaboration and co-operative activity between firms based in Ireland and also with the Irish public research system.

The Council supports the policy emphasis in recent years which has sought to increase collaboration between research institutes and both foreign owned, and Irish owned enterprises. Initiatives to increase knowledge transfer, particularly the mobility of personnel between research and enterprise are also welcome.

As set out in Innovation 2020 a correlation exists between engagement in collaboration activities and quantifiable increases in company turnover. These can be as much as seven times the investment in these instruments: for example, for every €1 invested in Innovation Vouchers<sup>175</sup> and Innovation Partnerships<sup>176</sup> respectively, it is estimated that company turnover increased by €7<sup>177</sup>.

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<sup>174</sup> European Commission, European Innovation Scoreboard, 2016

<sup>175</sup> The Innovation Vouchers initiative is open to all small and medium-sized limited companies registered in Ireland. The initiative is run by Enterprise Ireland although applications are not restricted to EI clients.

<sup>176</sup> The Innovation Partnership Programme, run through Enterprise Ireland can provide up to 80 per cent of the cost of research work to develop new and improved products, processes or services, or generate new knowledge and know-how. Participating companies must be a registered client of one of Enterprise Ireland, IDA Ireland, Local Enterprise Office, Údarás na Gaeltachta.

<sup>177</sup> Department of Jobs, Enterprise and Innovation, Innovation 2020, December 2015

In addition, novel initiatives such as the Health Innovation Hub Ireland (which is designed to drive collaboration between the health system and enterprise leading to the development and commercialisation of new healthcare technologies, products and services, emerging from within the health system and/or enterprise) are welcome. As part of Innovation 2020 the Department of Jobs, Enterprise and Innovation and the enterprise agencies are to review the enterprise support programmes across Departments and Agencies to ensure their comprehensiveness and complementarity. Such a review is welcome, as is the commitment to explore how to increase the private investment that is leveraged by these RDI support programmes (i.e. to increase the multiplier effect of public investment in these programmes).

While investment alone is no guarantee of success, ensuring that the impact of R&D expenditure from both public and private sources over the coming years is maximised should remain a cornerstone of policy<sup>178</sup>. Given the extreme pressures on the public finances in recent years, the policy emphasis has been on maximising the efficiency and impact of public research funding and increasing drawdown of funding through Horizon 2020.

The Council welcomes the continued emphasis in Innovation 2020 on maintaining a focus on research prioritisation particularly, with regard to maximising the impact and relevance of research for the economy (i.e. returns to competitiveness and high-value employment and human capital). An independent panel evaluation of the Research Prioritisation process concluded that while achievements to date in terms of the implementation of the exercise have been significant, "there is scope for improvement and the approach to the implementation of research prioritisation should be adapted to reflect experiences to date and the evolved socio-economic context"<sup>179</sup>.

In addition, as committed to in the Action Plan for Jobs 2016, a market-led horizon scanning exercise should be undertaken in order to identify strategic areas of commercial opportunity in global markets for Irish-based enterprises as the basis for the next cycle of research prioritisation which is due in 2018.

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**Recommendation:** Strengthen and develop enterprise innovation activity including collaboration and partnership with the public research system, with particular focus on firms that have not previously engaged in such collaboration.

**Responsibility:** Department of Jobs, Enterprise and Innovation, Enterprise Agencies

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**Recommendation:** Undertake a market-led horizon scanning to identify strategic areas of commercial opportunity in global markets for Irish-based enterprises as the basis for the next cycle of research prioritisation

**Responsibility:** Department of Jobs, Enterprise & Innovation

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**Recommendation:** Establish a new phase of Research Prioritisation drawing on the recommendations of the Report of the Independent Panel

**Responsibility:** Department of Jobs, Enterprise & Innovation

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<sup>178</sup> Indecon, Assessment of the Economic Impact of Exports on the Irish Economy, found that R&D-intensive sectors tended to have higher exporting intensities, after controlling for own-firm R&D and other factors. This is evident in the direct correlation with exports from R&D performing companies increasing from €44bn in 2003 to €117bn in 2013, while for non-R&D performing companies, exports decreased from €48bn to €26bn over the same period (innovative firms exhibit greater resilience than non-innovative firms). Their findings suggest the presence of a number of positive spillover impacts associated with exporting activity within the industrial base.

<sup>179</sup> Department of Jobs, Enterprise and Innovation, Review of Progress in Implementing Research Prioritisation - Report of the Independent Panel, 2015

European research framework programmes have always been an important element in providing international linkages and enhancing the excellence of the Irish research and development system. A target of €1.25bn for Ireland's drawdown of funding from Horizon 2020 was adopted. Horizon 2020 is structured into two- and three-year work programmes. The first work programme spanned the years 2014-2015; the current work programme spans the 2016-2017 and the final one will span 2018-2020.

In terms of the total Horizon 2020 budget for member states, 1.8 per cent has so far been allocated to Ireland. To date, Ireland has increased its share of eligible applications and signed granted approvals compared to the Seventh Framework Programme (FP7) and Ireland's project approval rate is particularly high in respect of Horizon 2020's SME instrument<sup>180</sup>. Ireland's overall success rate in the programme to date (15.3%) compares favourably with the average across all countries (13.3%).

A National Support Network has been put in place to work with researchers and companies to identify opportunities in Horizon 2020 and to assist them in preparing proposals for funding. The UK's decision to leave the EU has significant implications for Horizon 2020 funding when Article 50 (see Chapter 9) is triggered and it is important that Ireland is adequately prepared for any changes in Horizon funding.

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**Recommendation:** Continue to maximise the drawdown from Horizon 2020. In relation to Horizon 2020 funded research assess the potential opportunities and threats arising from the future disengagement of the UK from the EU.

**Responsibility:** Department of Jobs, Enterprise & Innovation, Horizon 2020 National Support Network, Enterprise Ireland

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While further exchequer funding is likely to be required to meet Ireland's stated target, private investment will continue to be a primary source of investment. In terms of business expenditure on R&D (BERD), Ireland's BERD intensity has been quite stable in the period 2009-2014 and amounted to 1.14 per cent of GDP in 2014. In total 73 per cent of gross expenditure on R&D was undertaken by the business sector in 2014. Services and manufacturing account for more than 95 per cent of the BERD expenditure with the foreign owned sector accounting for 70 per cent of BERD<sup>181</sup>. Irish owned enterprises engaged in R&D equate to 80 per cent of all R&D active enterprises with over 13,000 people engaged in R&D activity. For indigenous firms, innovation is at the heart of gaining competitive advantage and is central to their ability to compete in international markets.

However, Ireland's reliance on a relatively small cohort of FDI driven BERD expenditure is stark. CSO data shows the largest 100 enterprises in terms of R&D spend accounted for over €1.4bn, or 70 per cent, of the total R&D expenditure in 2013<sup>182</sup>. Of these top 100 enterprises, 80 per cent of expenditure can be attributed to foreign owned enterprises. In terms of financing, 90 per cent of all R&D expenditure was funded by enterprises' own funds, while 6 per cent of expenditure was funded from public funds. Small enterprises were more likely to use public funds, with 9 per cent of funding for these enterprises attributed to public funding.

The State's R&D Tax Credit scheme has been a key element of Ireland's strategy to increase BERD and to deepen the research capabilities of firms based in Ireland. The significant take-up by the enterprise sector of the R&D tax credit means that indirect public supports for R&D activities are now in financial terms larger than the direct measures to support in-company R&D provided by the State enterprise development agencies; the OECD calculated that in 2013,

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<sup>180</sup> European Commission, Horizon 2020, First Results, 2015

<sup>181</sup> European Commission, RIO Country Report 2015: Ireland, 2016

<sup>182</sup> CSO, Business Expenditure On Research And Development, 2015

R&D tax credits accounted for 70 per cent of all government supports (R&D investment as a percentage of GDP). Accordingly, it is important that Ireland's R&D tax credit and the new Knowledge Development Box achieve their objectives and remain internationally competitive and evolve to meet the needs of the enterprise sector – particularly emerging sectors and the needs of small and early stage firms as well as the needs of larger, established firms.

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**Recommendation:** Continue to develop our range of policies to further embed R&D activity in Ireland and to incentivise increased business expenditure on R&D (e.g. R&D supports, the R&D tax credit, relief on investment in intangible assets, and the new Knowledge Development Box). Ensure that these incentives remain internationally competitive and relevant to evolving enterprise needs in both the FDI and indigenous enterprise base.

**Responsibility:** Department of Finance, Department of Jobs, Enterprise & Innovation, Enterprise agencies

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### Enterprise Support Programme Evaluation

Over the period 2012-2014, Forfás - and subsequently DJEI - undertook a programme of evaluations across the full range of agency supports delivered by EI, IDA Ireland, SFI and the County and City Enterprise Boards (now Local Enterprise Offices). The evaluations made a number of recommendations across different individual programmes, as well as at Agency level. An assessment was carried out in Q1 2016 by the enterprise agencies and DJEI on the progress made by the agencies on the adaptation of programmes and the implementation of changes recommended in the evaluations. The assessment focused on:

- The measures the agencies have taken to implement changes recommended in relation to programme design and evaluation;
- The progress that is being made with regard to deepening an evaluation culture in the agencies;
- Ensuring independence of approach to evaluations; and
- Identifying any further steps that need to be taken.

APJ 2016 commits DJEI and its agencies to fully incorporate the recommendations emerging from the evaluations of the enterprise development agency programmes across all programmes by the end of 2016.

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**Recommendation:** Build upon the recommendations emerging from the evaluations of support programmes provided by the enterprise development agencies to support the most successful and impactful initiatives.

**Responsibility:** Department of Jobs, Enterprise and Innovation, Enterprise Ireland, IDA Ireland, Science Foundation Ireland, Local Enterprise Offices

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## Chapter 8: Increasing Labour Market Participation

### Why Participation Matters for Competitiveness

An economy primarily grows in one of two ways – either the quantity of inputs (e.g. labour, capital) increases, or the efficiency with which inputs are used improves (i.e. productivity – see Chapter 6). The scope to increase employment depends on the proportion of the working age population that make themselves available for work – this is referred to as the labour market participation rate. The challenge of growth, employment creation and inclusion are, therefore, closely interlinked.

Participation rates have been the focus of much discussion internationally, against a backdrop of ageing populations, which are adversely impacting upon labour supply. Policies which incentivise participation – particularly female participation can counter some of the impact of ageing societies, and can contribute to living standards and wellbeing. This is a particularly important challenge from Ireland. As it stands, Ireland has the highest percentage of people living in very low work intensity houses – and this is a particularly prevalent issue for single-parent households, with knock-on impacts in terms of increased risk of poverty and social exclusion<sup>183</sup>.

In parallel to efforts to increase the participation rate, the spectre of still-high unemployment, long term unemployment and youth unemployment still confronts us. While Ireland is on track to meet our commitments under the Europe 2020 Strategy to achieve an employment rate amongst those aged 20-64 to between 69-71 per cent, marginalised groups continue to endure higher rates of unemployment<sup>184</sup>.

Addressing the labour market needs of these groups and reducing involuntary unemployment will require continued evolution and innovation in relation to labour market activation policies. The fall in unemployment should facilitate a shift in activation policy away from 'activation in a time of recession' dealing with mass unemployment, to 'activation in a time of recovery and growth', more focused on the needs of vulnerable groups or cohorts more detached from the labour market. The interaction between the taxation and welfare systems – ensuring that work incentives are properly structured is crucial in this regard. In the longer term, investment in education is a key tool to reduce an individual's likelihood of becoming unemployed – there is a clear correlation between educational attainment and unemployment levels.

### Current Context

During the Celtic Tiger, a combination of an increase in the working age population and a higher propensity for individuals to participate in the labour force contributed to overall economic growth. According to the Central Bank, much of the increased labour force participation rate was a result of inward migration, which to a degree masked a fall in participation amongst the Irish population. During the crisis, both the supply of labour and the demand for labour fell sharply<sup>185</sup>. Despite a resurgent labour market, participation rates have not yet rebounded.

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<sup>183</sup> European Commission, Recommendation for a Council Recommendation on the 2016 National Reform Programme of Ireland and Delivering a Council Opinion on the 2016 Stability Programme of Ireland, COM(2016) 328, May 2016

<sup>184</sup> In Q1 2016, the employment rate in Ireland was 69.2 per cent; the male employment rate was 75.1 per cent and the female rate was 63.5 per cent. By comparison, the comparable rates in Q1 2007 were 73.7 per cent, 83 per cent, and 64.1 per cent respectively.

<sup>185</sup> As well as the impact of younger cohorts remaining in or returning to education, there was also an increase in the number of discouraged workers, especially amongst males aged 60-64 years exiting the labour market. See Department of Social Protection, Pathways to Work 2016-2020, January 2016

As a result of the depth and length of the recent crisis, the State's labour market interventions have been subject to an ongoing process of evaluation and reform. Over recent years in particular and in response to this process, interventions have become more targeted at groups with the greatest risk of disconnection from the labour market.

In seeking to design further interventions to boost participation in the labour force, it is important to understand whether the decline in participation has arisen as a result of cyclical factors (which can be expected to continue to unwind as the economy grows), or as a consequence of more structural (and, therefore, more difficult to address) factors.

The Central Bank has already conducted much of this analysis and found that a combination of structural and cyclical factors is at play: reductions in the male participation rate appear to be structural (reflecting largely demographic effects), while the trend in female participation has largely been driven by cyclical factors<sup>186</sup>. Looking at the medium-long term, it is forecast that labour force participation rate will continue to trend downwards. Some of the change of in the male participation rate is also likely to be driven by an increased propensity to participate in higher education – it is not clear at this juncture, however, whether the potential productivity gains arising from improved educational attainment will offset the loss from reduced labour supply<sup>187</sup>.

In this regard, the participation of marginalised groups (e.g. the low level of labour market participation for females aged 35 and over, in particular females without a third level education; the low level of participation amongst older males) is a key focus for this chapter. Based on analysis contained in the National Skills Strategy, there are over 880,000 economically inactive adults of working age in Ireland – from students, to those currently excluded from the labour market due to disability or ill health, those on home duties and the retired<sup>188</sup>.

Policies directed at enabling some members of these groups to participate in the labour market may, to a degree, provide a counterbalance to the potential negative structural (demographic) effects<sup>189</sup>. As such, these policies have the ability to increase Ireland's economic growth potential<sup>190</sup>. At the same time, migration policy will have a key role to play in addressing any shortfall arising as a result of demographic change.

### How Ireland Performs

This section summarises the key data on labour market participation and associated issues, based on the Council's previous analysis in *Ireland's Competitiveness Scorecard 2016*.

In terms of the labour market, it is clear that the labour market continues to improve – employment is increasing, whilst in parallel, unemployment continues to decline. Despite the positive trends, a number of concerns persist. Although unemployment amongst those aged 15-24 years in Ireland (20.9%) is now below the euro area average (22.4%), long term youth unemployment remains a serious challenge in Ireland (42.9%), compared with the euro area (34.6%). Ireland also has a high proportion of youth neither in employment, education or training, although this is declining.

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<sup>186</sup> Byrne, S., and O'Brien, Martin, Understanding Irish Labour Force Participation, Research Technical Paper 01/RT/16, 2016

<sup>187</sup> Other policies which will impact upon Ireland's demographic profile include changes to the State's pension age, which increased from 65 to 66 years in 2014, and will increase to 67 in 2021 and finally to 68 in 2028. Note that there is no statutory mandatory age for retirement in Ireland with the exception of certain Public Sector occupations.

<sup>188</sup> Department of Education and Skills, Ireland's National Skills Strategy 2025, January 2016

<sup>189</sup> The Central Bank results suggest that policy measures designed to increase the female labour force participation rate while being beneficial will not be sufficient to completely offset the demographic and other structural factors driving the lower trend participation rate over the next decade.

<sup>190</sup> The IMF has noted that significant macroeconomic gains can accrue from policies which facilitate increased female access to the labour market. See IMF, Women, Work and The Economy: Macroeconomic Gains from Gender Equality, IMF Staff Discussion No SDN12/10, September 2013

Participation rates in Ireland have remained relatively stable between 2010 and 2015, following a decline in the initial years of the recession. In Q1 2016, the participation rate was 63.7 per cent – well below the pre-recessionary peak of 68.6 per cent in Q3 2007<sup>191</sup>. In Q2 2016, the male participation rate was 67.8 per cent compared with a female participation rate of 53.6 per cent. While short-term changes in the participation rate can vary with economic cycles, the female participation rate in Ireland is consistently lower than those of best-performing EU economies.

Looking at the incentives to take up employment, a range of factors combine to influence the decision making process – income taxes and replacement rates are perhaps the most direct factors within State control, but the cost of childcare in particular is a major determinant of labour market participation.

For a long term unemployed, one earner married couple with 2 children earning 100 per cent of the average wage, the Irish replacement rate (80%) exceeds the OECD average (54.4%). The rate for single individuals (50.6%) also exceeds the OECD average (31.5%). Rates are higher for lower income families.

Data on the “implicit tax on returning to work” shows the cost of a second earner in a household taking up employment at 67 per cent of average wage<sup>192</sup>. In Ireland, significant disincentives exist, limiting the attractiveness of returning to work. The implicit cost of returning to work amounts to 90 per cent of potential earnings in Ireland compared with 57 per cent in the OECD. Looking specifically at the childcare-related costs and benefits (as a percentage of average wage - this data takes account of childcare fees, child benefit and relevant tax reductions) for couples, earning 167 per cent of the average wage, Ireland is the 2<sup>nd</sup> most expensive in the OECD, resulting in low rates of female labour force participation. For lone parents (67% of the average wage) Ireland is the most expensive OECD location.

In terms of policies designed to address activation, Ireland spends a large proportion of GDP (over 3%) on labour market programmes, reflecting the scale of our unemployment challenge. However, only 0.88 per cent of GDP is spent on active labour market programmes – well below leading EU performers. Income maintenance accounts for the largest proportion of expenditure in Ireland.

## Policy Challenges and Recommendations

### Ensuring Work Pays: Income Tax and Marginal Rates

A range of measures were introduced following the onset of the economic recession aimed at broadening the tax base. However, as the economy has recovered, we have seen a reversal of this approach and the tax base has once again narrowed (e.g. as a result of changes to the USC). In terms of incentivising participation in the labour force, a broad base with competitive marginal rates is preferable – in Ireland's case, the marginal tax rate on income (i.e. income tax, USC and PRSI) should be reduced below 50 per cent.

In discussing tax rates and income levels, it is necessary to point out that Ireland's high income tax rate takes effect at a relatively low income level (€33,800 for a single individual) compared to other jurisdictions: Ireland has the fourth lowest entry point to the highest rate of income tax of 34 OECD countries. Ireland's highest rate of income tax starts to apply at just below the average industrial wage; by comparison the UK top marginal rate applies at 4.2 times the

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<sup>191</sup> Participation rates are based on the Eurostat definition (i.e. the active population aged between 15 and 74 years, unless otherwise stated). As a result, figures differ from those published in the CSO's Quarterly National Household Survey which refers to the participation rate of the entire population aged over 15 years.

<sup>192</sup> Data is based on net transfers and childcare fees for households with two children aged 2 and 3. The indicator takes into account childcare fees and changes of taxes and benefits in case of a transition to a job paying two-thirds of average worker earnings.

average industrial wage. This issue is discussed in greater detail in Chapter 2. It is also worth noting that a revenue neutral shift from labour taxes to taxes on consumption could result in increased labour demand<sup>193</sup>.

The OECD notes that Ireland's social welfare system is effective in reducing poverty as supports are targeted at low income households. However, the downside of such an approach is that the marginal effective rate can be high, reducing the incentive to seek employment (see below)<sup>194</sup>.

The Irish income tax system generates sharp increases in marginal effective tax rates at various income points. For example, a significant spike in the marginal rate occurs as a taxpayer becomes liable for the Universal Social Charge (at an income level of €12,012); another spike in the rate occurs when taxpayers become liable for income tax and social security (€16,000-€18,000). Such spikes can have a significant impact on an individual's decision to return to work or to accept an increase in hours and as such represent an impediment to increasing the participation rate<sup>195</sup>.

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**Recommendation:** Reduce spikes in marginal tax rates to remove barriers to labour market participation.

**Responsibility:** Department of Finance

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**Recommendation:** Reduce the top marginal personal tax rates (income tax, USC and PRSI) to below 50 per cent. On an ongoing basis ensure that Ireland remains competitive relative to international comparators. To encourage labour market participation and the uptake of additional hours, provide for an internationally competitive entry threshold to the higher income tax rate that addresses those individuals in the middle income bracket.

**Responsibility:** Department of Finance

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### Social Welfare and Replacement Rates

The replacement rate measures the proportion of out-of-work benefits received when unemployed against take home pay if in work. In general, a replacement rate in excess of 70 per cent is considered to act as a disincentive to work (i.e. if an individual can receive more than 70 per cent of in-work income in benefits, they will demand a higher wage in the market to retain a monetary incentive to work). It is important to note, however, that replacement rates are not the sole determinant of the decision to take up employment – factors such as the cost of travel and childcare arising from the decision of an individual to return to work can have a significant impact on whether there is sufficient additional net income for the household to incentivise work, particularly for second earners.

At all times, policy makers must remain cognisant of the interdependency of the taxation system, social welfare and replacement rates, and the impact that policy changes can have on labour market participation. Most individuals face replacement rates of less than 70 per cent. Replacement rates (excluding housing benefits) tend to be lower for single people than for married couples – for example, a couple with 2 children and 1 earner on the average wage has a replacement rate of 66 per cent compared with a replacement rate of 35 per cent for single individuals earning the same amount.

The issue of secondary benefits and their impact upon an individual's incentive to take up an offer of employment merits specific consideration (i.e. secondary benefits increase replacement rates, and their loss upon the take up of

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<sup>193</sup> IMF, Fiscal Policy and Employment in Advanced and Emerging Economies, Prepared by the Fiscal Affairs Department, June 2012

<sup>194</sup> OECD, Economic Surveys: Ireland, 2015

<sup>195</sup> These spikes could be smoothed without raising the average effective tax wedge by using lower tax credits and more gradually rising income tax, USC and PRSI rates.



employment may create employment disincentives)<sup>196</sup>. At the same time, the impact of withdrawing secondary benefits on in-work poverty needs to be borne in mind. As pointed out by Watson et al., the rate at which such benefits are withdrawn as someone begins to work in what may be an insecure job needs to be carefully planned<sup>197</sup>.

Table 8.1: Net Replacement Rates in Ireland: Initial Phase of Unemployment

Family Does Not Qualify for Housing Assistance						Family Qualifies for Housing Assistance					
No children			2 Children			No children			2 Children		
Single	One-earner married couple	Two-earner married couple	Single	One-earner married couple	Two-earner married couple	Single	One-earner married couple	Two-earner married couple	Single	One-earner married couple	Two-earner married couple
35	56	62	48	66	68	50	72	62	63	80	68

Source: OECD

The issue of housing entitlements is especially important in relation to replacement rates. In particular, those in receipt of Rent and Mortgage Supplement tend to have higher than average replacement rates - this payment creates particularly high replacement rates because while it is available to those who are not in employment, in effect, it is not available to those who are in employment.

In terms of the scale of the challenge in relation to replacement rates, it is estimated that approximately 18 per cent of those in receipt of either Jobseekers Benefit or Jobseekers Allowance have a replacement rate in excess of 70 per cent. These rates are primarily driven by the receipt of means tested child benefits, means tested payments for a non-working or low income partner, and housing related payments discussed above.

Any consideration of policy change in relation to replacement rates must also take account of the varied functions that the social welfare system must fulfil. For example, the adequacy and sustainability of the welfare system must be maintained in light of both fiscal and demographic challenges. The system must also encourage the transition of individuals from welfare to work. At the same time, the system must also continue to provide targeted support to those who are most at risk of poverty<sup>198</sup>.

Reducing high replacement rates by reducing household income, however, is not an appropriate policy as it would run counter to the aim of reducing poverty, and would also reduce the incentive to work. The focus should switch, therefore, to in-work benefits. In light of the foregoing commentary, the ongoing piloting of the Housing Assistance Payment (HAP) which decouples housing support from social welfare payments is an essential element in removing barriers to employment and reducing replacement rates<sup>199</sup>. Similarly, the Summer Economic Statement proposes the

<sup>196</sup> Secondary benefits for those in receipt of Jobseekers Benefits and Jobseekers Assistance may include: Rent Supplement, Mortgage Interest Supplement, Fuel Allowance, Rental Accommodation Scheme (RAS), Medical Card and GP Visit Card, Back to School Clothing and Footwear Allowance, School Books Grant Scheme.

<sup>197</sup> Watson, D, Maître, B., and Whelan, C.T., Work and Poverty in Ireland: An Analysis of the CSO Survey on Income and Living Conditions 2004-2010, Department of Social Protection, 2012

<sup>198</sup> The European Commission has found that the Irish welfare system worked well in terms of containing the effects of the crisis on poverty and inequality. See European Commission, Commission Staff Working Document, Country Report Ireland 2016, SWD(2016) 77, February 2016

<sup>199</sup> HAP allows recipients to take up full-time employment and still keep their housing support. The introduction of HAP will mean that local authorities can now provide housing assistance for households who qualify for social housing support, including many long-term rent supplement recipients. Under HAP, local authorities will make payments, subject to rent limits, on behalf of the HAP recipient directly to the landlord in respect of rent. The HAP recipient will then pay a rent contribution to the local authority. The rent contribution is a differential rent – that is, a rent set by the local authority based on income and the ability to pay.

introduction of a new Working Family Payment that promotes work over welfare by supplementing, on a graduated basis, the income of a household, while at the same time incentivising more hours and full time work<sup>200</sup>.

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**Recommendation:** Complete the rollout of the Housing Assistance Payment. Monitor and evaluate its impact on replacement rates and on the likelihood of recipients transitioning into the labour market. All housing assistance payments should depend on income rather than employment status.

**Responsibility:** Department of Social Protection

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**Recommendation:** Further develop the concept of the Working Family Payment, outlining how it differs from existing payments and schemes (e.g. Family Income Supplement, Back-to-Work Family Dividend), and the expected impact of such a payment on family income and labour market outcomes.

**Responsibility:** Department of Social Protection

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In the longer term, much like the debate around the simplification of our income tax system, it is opportune to consider the fundamental nature and role of our social welfare system. In particular, a holistic overview of how the social welfare system can best be structured to support employment, tackle structural inequality and address the risk of embedded poverty.

The IMF has previously noted that in Ireland (in contrast to most other EU members), unemployment benefits do not vary with the duration of unemployment<sup>201</sup>. It was further noted that such a flat structure of unemployment payments can lead to disincentives for a minority of job seekers (e.g. through the creation of poverty traps) and as a consequence could contribute to lower exit rates from the Live Register<sup>202</sup>.

While welfare payments remain flat (and can increase) over employment duration, it is likely that the individuals earning potential will decline over time – there is a negative relationship between work interruptions and skills, with a long period of unemployment likely to result in lower earnings potential which in turn contributes to increasing replacement rates over time.

The potential to reform the social welfare system so that benefits decline in line with the length of time a person is out of work should be considered. It is important to note, however, that this 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).

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**Recommendation:** Reform the social welfare system so that replacement rates decline in line with the length of time a person is out of work. Early and timely labour market interventions (i.e. enterprise relevant training) are required to support such an approach.

**Responsibility:** Department of Social Protection

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200 Family Income Supplement (FIS) compensates lower-income working families with children for the withdrawal of welfare upon return to work. The OECD also notes that FIS payments fall rapidly with income. As a result, those with low income face high marginal effective tax rates of over 60 per cent. Following ESRI analysis, the OECD suggests that FIS should be reduced more gradually as income increases. See OECD, Economic Surveys: Ireland, 2015

201 IMF, Country Report No. 12265, Ireland: Selected Issues, September 2012

202 IMF, 2012 Article IV Consultation with Ireland - Concluding Statement of the IMF Mission, 18 July 2012

### Labour Market Activation

Amidst the positive developments in both the economy and labour market, the risk of embedded structural unemployment persists, particularly in relation to long term unemployment and youth unemployment. As part of our Europe 2020 target to increase the employment rate to 69-71 per cent, there is a specific reference to achieving this target through “the greater participation of young people, older workers and low-skilled workers, and the better integration of legal migrants”. To reach all of these groups, targeted activation policies that help unemployed people stay close to the labour market and to maintain and update their skills, are vital.

The importance of effective activation policies and programmes is recognised in the latest National Skills Strategy<sup>203</sup>. Acknowledging the shift from an economy in crisis to an economy experiencing strong employment growth, a number of the Strategy's key objectives reference the labour market. In this regard, the Strategy states that “education and training providers will place a stronger focus on providing skills development opportunities that are relevant to the needs of learners, society and the economy”; that there will be a “specific focus on active inclusion to support participation in education and training and the labour market”; and that the Strategy “will support an increase in the supply of skills to the labour market”.

Ireland's twin strategies - Action Plan for Jobs and Pathways to Work – remain the basis of reforms to increase labour market participation and make work pay<sup>204</sup>. In particular, the Pathways to Work Strategy prioritises the activation of the long-term and young unemployed<sup>205</sup>. It also plans to extend services and supports to other cohorts currently not registered as unemployed but interested in playing a more active role in the labour force. Pathways to Work also reflects a shift in focus from ‘activation in a time of recession’ to ‘activation in a time of recovery and growth’.

In their most recent review of Ireland, the European Commission have acknowledged the progress made to date in this space (notably the integration of benefits and employment services in Intreo, and the tailoring of supports to meet the needs of individuals). However, the Commission also highlight concerns about the effectiveness of some existing activation policies and employment support schemes (e.g. Back to Education Allowance<sup>206</sup>). In other developments, the OECD highlights the extent of labour market activation reform undertaken in Ireland since 2013, including:

- The launch of JobPath to put activation policies for the long-term unemployed on a more systematic footing;
- The provision of additional State resources for internships and the Momentum programme (which provides vocational training for the long term unemployed);
- The provision of additional staff to focus on activation duties;
- A greater focus on youth unemployment in response to the EU Youth Guarantee programme; and
- The development of a more systematic approach to evaluation of labour market programmes.

The Council has long advocated for comprehensive evaluation of all publically funded programmes. In this particular space, an evaluation of the Intreo activation process is underway whilst a review of the JobBridge scheme has been completed. Further evaluations planned (for the Back to Work Enterprise Allowance, Community Employment and Community Work Placement Initiative (TÚS)). These evaluations are of the utmost importance, and it is vital that the emerging findings are disseminated and used to ensure that programmes are further aligned to the needs of participants and employers.

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<sup>203</sup> Department of Education and Skills, Ireland's National Skills Strategy 2025, January 2016

<sup>204</sup> There are a range of other strategies designed to ensure that Ireland's workforce is not just fully employed but is equipped to respond flexibly to the demands of a growing economy. These include the Comprehensive Employment Strategy for People with Disabilities 2015-2024, the Further Education and Training Strategy 2014-2019, and the abovementioned National Skills Strategy 2025.

<sup>205</sup> Department of Social Protection, Pathways to Work 2016-2020, January 2016

<sup>206</sup> Kelly, E., McGuinness, S., Walsh, J.R., An Evaluation of the Back to Education Allowance, Economic and Social Research Institute, ESRI, 2015

JobPath is a new approach to employment activation which caters mainly for people who are long-term unemployed (over 12 months) to assist them to secure and sustain full-time paid employment or self-employment. Following the completion of a public procurement process, contracts to deliver JobPath were signed with two companies – Seetec Limited and Turas Nua Limited. With JobPath being rolled out to additional locations in 2016, it will be essential to monitor the effectiveness of the approach and to conduct an evaluation on its success as early as possible (i.e. once sufficient data is available to effectively assess outcomes).

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**Recommendation:** Continue to evaluate labour market activation programmes and to use the findings from such evaluations to reform and align programmes to better match the needs of participants and employers. Conduct an evaluation of JobPath as soon as is practicable.

**Responsibility:** Department of Social Protection, SOLAS

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Further, the appropriateness of programmes, such as JobBridge, has been considered in light of the improving labour market. With employment increasing and strong economic growth forecast, JobBridge (which achieved positive results in terms of participants' transition into employment) is to be replaced in 2017 with a revised internship programme which will see those out of work take up work experience and receive the minimum wage. The Council believes the new programme should provide participants with an opportunity for training and potential employment, should include provisions to minimise the potential for abuse and displacement, and should encompass a greater employer contribution (e.g. top-ups should be funded by employers rather than the State; consideration should also be given to mandating that top-up rates bring participants up to the relevant national minimum wage rate once they have completed a defined period of their internship).

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**Recommendation:** Replace JobBridge with a reformed internship programme which delivers increased opportunity for interns to progress to employment within the host organisation, with a particular focus on low skilled, youth unemployment and long term unemployment.

**Responsibility:** Department of Social Protection, SOLAS

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### Childcare Costs and Labour Market Participation

Insufficient access to affordable, full-time of childcare in Ireland has been the subject of much debate for a long time in Ireland. The European Commission recently noted that the limited availability and the high costs of childcare represents a significant barrier to increasing female labour market participation (and also hinders efforts to reduce child poverty)<sup>207</sup>.

For households with children, the additional costs associated with childcare can represent the largest additional costs associated with taking up either part-time or full-time employment<sup>208</sup>. Childcare costs in Ireland are the second highest<sup>209</sup> in the OECD for couples and the highest in the OECD for lone parents, and are not offset, as in some other

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<sup>207</sup> European Commission, Commission Staff Working Document, Country Report Ireland 2016, SWD(2016) 77, February 2016

<sup>208</sup> Collins, M. et al, The Cost of Work: Insights from Minimum Income Standards, Research for Ireland, Nevin Economic Research Institute Working Paper, NERI WP 2012/No 3, May 2012

<sup>209</sup> This is based on couples where the first earner earns 100 per cent of the average wage and the second earns 67 per cent of the average wage; the lone parent calculation refers to a person earning 67 per cent of the average wage.

countries, by benefits in the form of subsidies, direct payments etc. It is also worth noting that Ireland has the highest percentage in the EU of households consisting of a lone parent with dependent children (7.1 per cent compared with an EU average of 3.6 per cent). The impact of such costs on the participation rate of potential second earners in households is therefore of concern. The *Programme for Partnership Government* contains a commitment to review the costs of childcare provision – any moves to respond to the cost burden must be built on solid analytical foundations, and so this review should be undertaken as a matter of urgency<sup>210</sup>.

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**Recommendation:** Undertake an independent review of the cost of providing quality childcare in private and community settings, consistent with the principle of ongoing professionalisation of the sector.

**Responsibility:** Department of Children and Youth Affairs

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As noted above, female labour participation rates in Ireland remain below the EU and euro area average – and maternal employment rates are lower than for women as a whole<sup>211</sup>. The cost of childcare is likely to be a major explanatory factor for this low participation rate. Recent research by the European Commission on secondary earners in Europe concluded that “*out-of-pocket childcare costs are likely to influence employment decisions as much as, if not more than, 'explicit' fiscal (dis)incentives*”<sup>212</sup>.

As well as potentially increasing female participation rates, the availability of affordable, accessible, high quality childcare would also improve quality of life, and would improve Ireland's overall attractiveness in terms of attracting talent and encouraging emigrants to return. Increased female participation would also help to address skills shortages. To date, much of the dialogue in relation to childcare and the role of the State has focused on the educational benefits which accrue through early childhood and pre-primary education. While childcare policy must be informed by important social, education and quality of life considerations, from a national competitiveness perspective, the impact of childcare policy on the labour market must be considered. There is a need to strike an appropriate balance between increasing labour market participation and removing the barriers preventing participation, whilst maintaining cost competitiveness for enterprise, and ensuring fiscal sustainability for the State<sup>213</sup>. At the same time, there must be recognition that the pay and conditions of childcare professionals are pivotal to the development of a high-quality model of care<sup>214</sup>.

A number of recent developments are worth referencing. Most notably, Budget 2016 announced that an additional €47 million would be made available to provide a second free year of preschool education for children from 3 years of age (i.e. the extension of the Early Childhood Care and Education scheme). Additional funding was announced in Budget 2017 enables the further roll out of the Scheme - parents now benefit from an average of 61 weeks of free pre-school, saving an average of €4,000 on their childcare costs for each eligible child.

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210 A Programme for a Partnership Government, May 2016

211 Having a pre-school child reduces the likelihood of participation by 17 to 20 per cent and having a child aged 5 to 12 years reduces the probability of participating by between 7 and 9 per cent. See Russell et al, A Woman's Place: Female Participation in the Irish Labour Market, Equality Research Series, ESRI and The Equality Authority, November 2009

212 Rastrigina, O., and Verashchagina, A., Secondary Earners and Fiscal Policies in Europe, European Commission, Directorate-General for Justice and Consumers, 2015

213 A recent report by Public Policy.ie estimates Irish Government expenditure on children in Ireland; in 2013 it is estimated that €11.89 billion or €10,352 per child was spent on a variety of services, ranging from education to health and social welfare. See Redmond, P., Estimating Government Expenditure on Children in Ireland, PublicPolicy.ie, August 2016

214 ICTU, Who Cares? Report on Childcare Costs and Practice in Ireland, Spring 2016

While welcome, the limited number of hours provided (3 hours a day) and other capacity constraints limit the impact that this will have on both costs to parents, and subsequently on the labour market. It is also important to note that the scheme is not designed as a form of childcare; rather its primary purpose is educational in nature<sup>215</sup>.

The report by the Inter Departmental Group on Future Investment in Childcare was published in 2015 and identifies and assesses policies and future options for increasing the quality, accessibility (including supply) and affordability of early years and school-age care and education services in Ireland<sup>216</sup>. It identifies three strands for action over the coming years:

- i. Incremental investment in subsidising fees through existing and reformed schemes;
- ii. Measures to make sure there is adequate supply for future demand; and
- iii. Measures to embed quality in the sector.

Subsequent to the publication of the report, Budget 2016 outlined plans to roll out a Single Affordable Childcare Scheme providing simplified childcare subsidies. This was further developed in Budget 2017, and is intended to replace the existing Community Childcare Subvention (CCS)<sup>217</sup>, along with the Training and Employment Childcare programmes, comprising the After-School Childcare, Childcare Education and Training Support, and Community Employment Childcare.

This new scheme is a major step in making childcare more affordable, and will enable both universal and targeted subsidies for parents towards childcare costs. Parents will qualify for a targeted subsidy based on their net income. Subsidies will be available for children aged from 6 months up to 15 years and will meet families' full-time childcare needs, including outside of school hours and during school holiday time. The highest levels of subsidy will be provided to those on the lowest incomes, approx. €8,000 a year based on the maximum of 40-hours childcare a week. This will help families to overcome disadvantage and contribute to a reduction in child poverty.

In addition, Budget 2017 also provides for the introduction of a universal measure for parents of children aged from 6 months to three years. From September 2017 a universal subsidy of up to €80 per month will be provided towards childcare costs for parents working full time. This will be payable to childcare services registered with Tusla.

The Council welcomes the rollout of the Single Affordable Childcare Scheme and believes that it will have a significant positive impact on labour market participation. However, as currently envisaged, it is a targeted scheme designed to support low income families. As such it is insufficient to address the challenges facing many families whose income level exceeds the threshold. Consideration of how best to sustainably increase State investment in order to extend the Scheme to benefit all working families is now required.

The costs and benefits to the State arising from the –scheme should be rigorously assessed in terms of their impact on enterprise costs; on employer and employee behaviour; and on the level and quality of service provision.

The OECD has also identified the need to achieve a greater balance between expenditure on cash benefits and childcare services<sup>218</sup>. In Ireland, these account for 3 per cent and 1 per cent of GDP respectively compared with 1.3 per cent and 1 per cent of GDP on average in the OECD. In the medium term the merits of shifting the balance of

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<sup>215</sup> The NCC has previously advocated for public investing in pre-primary or early childhood education as a means to simultaneously promote social justice and productivity in the economy. See NCC, Statement on Education and Training, Forfás, February 2009

<sup>216</sup> Report of the Interdepartmental Working Group on Future Investment in Early Years and School Age Care and Education Services, July 2015

<sup>217</sup> The CCS Programme supports disadvantaged parents, parents in low paid employment and parents in training or education, by enabling those who qualify to avail of reduced childcare costs at participating community/not-for-profit childcare services.

<sup>218</sup> OECD, Economic Survey of Ireland 2015, September 2015

expenditure in Ireland (and the role of universality of Child Benefit) should be examined in terms of its likely impact on labour supply. It will also be important to ensure that parents choosing not to work are not disadvantaged by any reforms vis-à-vis their current situation.

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**Recommendation:** Rigorously assess the impact of the Single Affordable Childcare Scheme on enterprise costs and on labour market participation. Examine the potential to extend the application of the Scheme to all working families.

**Responsibility:** Department of Children and Youth Affairs

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**Recommendation:** Increase the provision of quality, affordable childcare options.

**Responsibility:** Department of Children and Youth Affairs

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Given the rapid increase in State expenditure in the childcare space, an increase in demand for Tusla accredited facilities can be expected. It is important that Tusla and indeed the wider childcare sector have sufficient capacity to meet this demand. Further, it is likely that any supply response from childcare providers will result in increased administrative burdens. To ensure the effective rollout of the Scheme, it is essential that these concerns are addressed in a comprehensive implementation plan. In this regard the provision of additional funding to enhance and extend the Early Years Inspectorate within Tusla is welcome<sup>219</sup>.

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**Recommendation:** Publish a detailed implementation plan to cover all aspects of the Single Affordable Childcare Scheme. Ensure that the additional administrative and regulatory implications of the Scheme are addressed in a manner that facilitates the rapid and efficient rollout of affordable childcare to working families.

**Responsibility:** Department of Children and Youth Affairs

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<sup>219</sup> A recent Ibec publication considers approaches to inspection etc. designed to minimise costs and administration. See Ibec, Labour Market Participation of Women, October 2016

## Chapter 9: Brexit and Irish Competitiveness

### Why Brexit Matters for Competitiveness

The decision by British voters to leave the European Union has far reaching, if somewhat uncertain consequences for everyone in Europe – not least for the future direction of the EU project itself<sup>220</sup>.

From an Irish perspective, it has short term and long term implications across a range of policy areas which directly impact upon our national competitiveness – including implications for trade, investment, the labour market, and energy, as well as many sector specific competitiveness impacts – particularly on the agri-food, financial and tourism sectors. Brexit will also impact at the level of the individual firm, and will certainly pose challenges in terms of North-South relations on the island of Ireland.

The economic and political implications of Brexit – and indeed the institutional arrangements between the UK and EU, and between Ireland and the UK – remain unclear at this juncture. What must continue to be made clear, however, is Ireland's consistent commitment to the EU. In uncertain times, this relationship represents a key strength for us. Likewise, our traditional close political, economic and social ties to the UK must be protected and fostered.

Ultimately, policies to protect our international competitiveness must remain a priority for policy makers; only by maintaining and enhancing Ireland's international competitiveness can we build an economy sufficiently robust and adaptable to withstand whatever the turbulent global economic environment throws at us. Only a renewed commitment to improving our competitiveness will put us in a position to take advantage of whatever opportunities emerge as a result of the changed European dynamic.

### Current Context

The interconnection of the Irish and British economies has been well rehearsed throughout the Brexit campaign.

From a **trade** perspective, 15 per cent of Irish merchandise exports go to the UK and 30 per cent of our imports come from the UK. Irish exports, particularly merchandise exports tend to be concentrated in a small number of sectors and a small number of products<sup>221</sup>. This narrow base means that Irish exporters may be more vulnerable to sector-specific trade barriers or to any other developments which weaken our relative export competitiveness<sup>222</sup>.

Looking at our indigenous companies, in 2015 approximately 37 per cent (or €7.5 billion) of Enterprise Ireland client company exports went to the UK. It is important to note that while the UK remains a vital market, over time the dependence of the indigenous sector on the UK has been declining: in 2005, 45 per cent of EI client company exports went to the UK. Other markets have also grown strongly in recent years, providing a counter-weight to the importance of the UK market<sup>223</sup>. The treatment of goods passing through the UK on their way to and from Ireland also bears consideration (i.e. whether additional tariffs or custom duties are applied to such goods), as does the impact of Brexit on the freight sector.

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220 Brexit also seems likely to result in further delays in relation to the normalisation of monetary policy.

221 The Department of Finance has published a paper examining the trade exposures of sectors of the Irish economy to the UK in light of Brexit. See Department of Finance, UK EU Exit – An Exposure Analysis of Sectors of the Irish Economy, October 2016

222 Narrowly applied trade barriers on the products or sectors where Irish exports are concentrated could have very significant implications. The UK market is particularly important for Agriculture, Food and Textiles, which have been found to benefit particularly from free trade through EU membership, suggesting that these may be particularly exposed to the negative impacts of Brexit.

223 Nevertheless, analysis of trade data suggests that the nature of the merchandise trade relationship between Ireland and the UK is different to that with the other trading partners. In particular it indicates the continuing importance of the UK as a supplier of intermediate and consumption goods for Ireland.



Through currency effects, there are at least short term cost implications: for Irish exporters, many of whom are dependent on the UK market, the depreciation of sterling is resulting in higher costs and diminished competitiveness relative to UK produced goods and services. Conversely, imports to Ireland from the UK are becoming more competitive. The permanency of the exchange rate shift also bears consideration. The re-emergence of trade impediments could increase the cost of exports and increase Irish inflation.

The aforementioned currency effects will also have significant implications for the Irish tourist industry – UK visitors represent the single largest category of tourist coming to Ireland<sup>224</sup>. Overall, the ESRI estimate that bilateral trade flows between Ireland and the UK could decline by up to 20 per cent on current levels, depending on the type of agreement reached on post-Brexit structures.

In terms of **investment** the EU remains the 3<sup>rd</sup> largest investor into Ireland – while the EU accounts for the largest proportions of FDI stock in the UK. The ESRI have predicted that Brexit will result in a likely fall in foreign direct investment into the UK with a knock-on contraction in UK economic demand which would adversely impact on Ireland. To counteract this, it is likely that the UK will continue to take steps to enhance its attractiveness to FDI through other means, including further reductions to its corporate tax rate<sup>225</sup>. On the other hand, Ireland's strong and ongoing commitment to remaining within both the EU and the single currency may enhance our attractiveness to potential investors seeking an EU base who would have previously considered locating in the UK. Indeed, many commentators expect that Brexit will have a greater impact on the attractiveness of other locations for FDI than on Ireland, which is already a higher performer in the FDI stakes. The possibility of Irish based companies who are dependent on the UK market as a destination for exports relocating to Northern Ireland also needs to be considered.

The close relationship also extends to the **labour market**. Historically, and even preceding the creation of the single market, Ireland and the UK enjoyed a common labour market, that has mutually benefitted both countries. In 2011, over 400,000 Irish passport holders were resident in the UK, while 230,000 British passport holders were resident here. While historic and cultural ties will persist, the continued free movement of labour is now under threat and Brexit will most likely result in restrictions in people movement especially for purposes of work. However, any restrictions will not just impact Irish people seeking to move to the UK - restrictions on migrants could mean that some will divert to Ireland with implications for the Irish labour market in terms of unemployment rates and wage levels.

The **energy** implications for Ireland of Brexit could be significant. We remain extremely dependent on energy imports from the UK – with 85 per cent import dependency in 2014. Oil accounts for 49 per cent of total energy use in Ireland, and 76 per cent of oil imports come from the UK; in terms of electricity generation, 46 per cent is generated using natural gas, and 96 per cent of our gas is also imported from the UK<sup>226</sup>. Since 2007 Ireland has benefited from the creation of an all-island energy market and interconnection with the UK. Brexit could give rise to energy security issues for Ireland that might require significant once off investments, including, for example, investments in energy storage and an interconnector to France<sup>227</sup>. There are also implications in relation to EU rules on climate change and renewables<sup>228</sup>.

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224 Residents of Great Britain took more overnight trips to Ireland than visitors from any other part of the world. Visitors from Great Britain accounted for 41 per cent of all foreign trips to Ireland in 2014. See CSO, Visitors to Ireland and Northern Ireland 2014: A Statistical Profile of Tourism, February 2016

225 The UK's current 20 per cent corporate tax rate is due to be reduced to 19 per cent in April 2017, and to 18 per cent in April 2020. Following the Brexit result, the then British Chancellor George Osborne suggested that the UK's corporation tax rate would be cut to below 15 per cent, although no timeframe for any such cut was provided.

226 SEAI, Energy Security in Ireland: A Statistical Overview, 2016

227 Under existing EU regulations, Ireland currently relies on the UK for emergency energy supplies (i.e. the UK acts almost as a "lender of last resort" for energy).

228 While the UK will no longer be subject to EU rules, UK domestic law - which provides for even more far-reaching and ambitious climate related goals – will still apply. As adherence to EU targets would no longer apply, Brexit would make it easier in the future for the UK to abandon a domestic policy agenda to tackle climate change, but the act of leaving the EU in itself will not automatically result in this course of action taking place. The UK had assumed a greater percentage of the EU climate change targets overall relative to their size; Brexit could result in an additional 1-2 per cent increase in the climate change targets for individual member states. See The Economist Intelligence Unit, Out and Down: Mapping the Impact of Brexit, 2016

Beyond the impact of Brexit across a range of individual sectors – notably the agri-food, financial and tourism sectors – it is possible that the combination of increased uncertainty and the introduction of additional currency controls, capital requirements and other cost-increasing regulations could adversely impact upon banks' ability to lend, which in turn could weaken the investment environment for enterprise.

In terms of the **overall economic impact**, the uncertainty arising from the Brexit decision will almost certainly result in lower growth for the global economy, with direct consequences for Irish growth prospects<sup>229</sup>. While estimates of the potential loss to the UK economy vary, and depend on the assumptions about the precise format that Brexit will take – the close ties between Ireland and the UK mean that a decline of 1 per cent in UK GDP result in a decline of approximately 0.3 per cent in Irish GDP and a decline of 0.2 per cent in Irish employment. Ireland would also be impacted by second-order impacts: for example, the imposition of trade barriers between the UK and third party countries with which we trade (e.g. France or Germany), would lower growth in those countries also, with knock-on effects for Ireland.

### Expected Impact of Brexit on the UK

While in Ireland we are most immediately concerned about the consequences for our own economy and our international competitiveness, Brexit naturally will also impact upon the UK's economy and competitiveness performance also. As is the case from the Irish perspective, the exact scale and nature of the impacts arising from Brexit will depend upon the type of negotiated exit agreed – Brexit negotiations may essentially come down to a trade-off between the UK's ability to control immigration, and its ability to continue to access the single market. Regardless, it is expected that the effects of Brexit will not be distributed evenly, either across sectors or across time. Indeed, the Economist Intelligence Unit expects the shock of a "Brexit" will be front-loaded, but will stretch out to at least 2020<sup>230</sup>. The ESRI have noted that the expected losses to the UK are likely to outweigh the savings (from the cancelled EU budget contributions).

In terms of the possible effects of Brexit, on the down side (as with Ireland), the UK is a net energy importer, and Brexit may pose challenges in relation to energy investment and interconnection. UK companies may also miss out on the potential additional digital sales arising from the development of a Single Digital Market in Europe. At a sectoral level, Brexit increases the risks for telecoms and financial service companies.

On the other hand, the UK may not be constrained by EU rules relating to State Aid, or climate change, giving them the opportunity to put in place a more enterprise-friendly regulatory environment. The increased scope to enhance their international tax competitiveness also represents a potential upside for the UK<sup>231</sup>.

Overall in the short term, the UK can expect a degree of volatility and uncertainty, manifesting itself in the form of sterling depreciation and lower growth forecasts. Thereafter (c.2017-18), higher import costs, reduced consumer spending, weaker investment, and an increase in unemployment could result in a contraction in GDP by as much as 3 per cent. As the longer term reality of Brexit becomes clear, the EIU estimate that UK GDP could be up to 6 per cent below baseline by 2020. Other forecasts (taking account of the dynamic effects such as lower productivity growth in addition to more immediate impacts) suggest that the loss to the UK could range between 6.3 and 9.5 per cent of GDP.

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229 A recent ESRI paper uses the new Core Structural Model of the Irish economy (COSMO) to attempt to quantify the medium to long-run impact of BREXIT on the Irish economy under a series of alternative scenarios. See Bergin, A., et al, Modelling the Medium to Long Term Potential Macroeconomic Impact of Brexit on Ireland, ESRI, Working Paper No. 548, November 2016

230 The Economist Intelligence Unit, Out and Down: Mapping the Impact of Brexit, 2016

231 The UK would still be influenced by other international bodies such as the OECD (and the Base Erosion and Profit Shifting project), the Common Reporting Standard (the global standard for exchange of financial account information between tax authorities), and other transparency measures, such as country-by-country reporting.

Given the large impact that Brexit will have on the Irish economy (and indeed on Irish society), significant political and analytical resources have already been assigned to develop an Irish response. A contingency framework, coordinated by the Department of the Taoiseach is already in place. Using this Framework, Ministers, Departments and Agencies are tracking and adapting the detail of contingencies and risk management strategies arising in each of the key strategic, policy and operational areas identified.

As noted in the Framework, Ireland – as a committed Member State of the EU - will work within the EU context. At the same time, Ireland has unique bilateral interests with the UK, including with regard to Northern Ireland, and the Government will also have to work bilaterally in close contact with the UK Government and the devolved Administration in Northern Ireland.

Finally, the impact of Brexit on Ireland's engagement with the EU's political and administrative apparatus in Brussels is potentially significant. For a variety of cultural, historic and economic reasons, Irish and UK positions in relation to EU policies often tend to be closely aligned. The UK not only provides Ireland with a heavy-hitting ally with similar outlooks and interests, but Ireland also tends to benefit from the large resources that a large country such as the UK dedicates to analysing and influencing the EU policy making process. In the absence of the UK, Ireland will need to continue to cultivate alliances with other Member States, and consider how best to maximise our influence.

### How Ireland Performs

Competitiveness has been central to Ireland's improved economic and enterprise performance. Our improved competitiveness since 2009 is reflected in a range of international competitiveness rankings. Against the backdrop of Brexit, Ireland's relative performance vis-à-vis the UK assumes greater importance.

Table 9.1: Irish and UK World Bank Doing Business Rankings, 2017

	UK	Ireland
Ease of Doing Business	7	18
Starting a business	16	10
Dealing with construction permits	17	38
Getting electricity	17	33
Registering property	47	41
Getting credit	20	32
Protecting minority investors	6	13
Paying taxes	10	5
Enforcing contracts	31	90
Trading across borders	28	47
Resolving insolvency	13	17

Source: World Bank

The World Bank's Doing Business assesses regulations affecting SMEs, and measures regulations applying to companies throughout their life cycle. In 2017, Ireland is ranked 18<sup>th</sup> – a fall of 1 places from last year<sup>232</sup>. Our top 20 ranking indicates that Ireland has a comparatively good enterprise environment conducive to doing business. However, the World Bank rankings show Ireland lags the UK (ranked 7<sup>th</sup>), and highlights a number of areas in which there is significant room for improvement (e.g. Ireland is quite far behind the UK in terms of the cost and time taken to enforce contracts – see Table 9.1).

Similarly, the WEF's Global Competitiveness Report provides an assessment of the factors driving productivity and prosperity across 140 countries. In the 2015-16 report, Ireland is ranked 24<sup>th</sup> - an improvement of 1 place from last year. Ireland scored 5.11 (out of 7) and is ranked as the 8<sup>th</sup> most competitive economy within the euro area, and 11<sup>th</sup> most competitive in the EU. The UK, however, is ranked 10<sup>th</sup> overall (with a score of 5.43).

Competitiveness is a relative measure, and as noted, the UK is likely to implement a range of policies to enhance the attractiveness of their business environment over the coming months and years. Brexit places a clear light on our own competitiveness and it is important that we understand Ireland's strengths and weaknesses – not just in relative terms but also in terms of direct comparison with the UK.

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**Recommendation:** Undertake a benchmarking exercise comparing Ireland's performance across a range of key competitiveness metrics with the UK and Northern Ireland.

**Responsibility:** National Competitiveness Council

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### Policy Challenges and Recommendations

Regardless of the shape that the UK's negotiated withdrawal takes, it will remain an important market for Irish exporters – a market of 65 million English speaking customers. Likewise, the UK will continue to be a key source of imports for Ireland. Economic theory and past experience tells us that the reintroduction of trade barriers is likely to lead to welfare losses for all parties concerned. Therefore, given the linkages between the two economies, it would seem that the more the UK can retain access to the EU, the greater the benefits for Ireland.

At the same time, individual sectors will be impacted differently by the changed relationships between Ireland, the UK and the EU. It is important that our negotiating position is underpinned by robust economic analysis and a clear understanding about potential winners, losers and trade-offs which may arise as a result of Brexit.

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**Recommendation:** Advocate for an agreement between the UK and EU that maintains as much mutual access to markets as possible.

**Responsibility:** Department of the Taoiseach, Department of Jobs, Enterprise and Innovation, Department of Foreign Affairs and Trade

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As noted above, the implications of Brexit on internationally mobile investment are difficult to determine at this juncture. What is clear, however, is that the UK is likely to continue to enhance the competitiveness of its corporate tax

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<sup>232</sup> Ireland is 5<sup>th</sup> in the euro area behind Finland, Germany and Estonia but ahead of many comparators including, Netherlands and Spain.

regime, in a bid to retain existing investment, and to attract new investment. Other EU Member States are also likely to enhance their own initiatives to attract investment from companies reconsidering their UK investments.

From a corporate tax perspective, it is essential that Ireland remain competitive. A low effective corporate tax rate is a key factor when assessing the competitiveness of a country's tax system. Current international tax developments (e.g. the OECD's Base Erosion and Profit Shifting process) represent positive opportunities for Ireland to retain, embed and attract substantive activity as part of efforts to strengthen our overall tax system.

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**Recommendation:** Maintain Ireland's commitment to the 12.5 per cent corporation tax regime.

**Responsibility:** Department of Finance

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In relation to the labour market, the Common Travel Area between Ireland and the UK has been of particular benefit to Ireland. Likewise, the participation of both the UK and Ireland in the single European labour market has provided both countries with access to skills and labour. Any moves to limit access to the UK labour market as a result of Brexit could potentially result in upward pressure on Irish unemployment and downward pressure on Irish wages; the possible diversion of migrants from the UK to Ireland, given our shared language, must also be considered.

At the same time, any limitations imposed on UK immigration, could potentially provide Ireland with an opportunity to attract high skilled migrants here, regardless of nationality. It is important, therefore, that Irish visa and employment permits systems are efficient, effective and meet the needs of both potential migrants and enterprise. In this regard, recent initiatives such as the rollout of the online employment permit application system and the Trusted Partner Initiative are welcome<sup>233</sup>.

Any moves to end the Common Travel Area (CTA) pose particular challenges for Ireland, given our land border with Northern Ireland and the aforementioned labour market interlinkages between the UK and Ireland. The CTA has been in operation since the 1920s (although it is not specifically provided for in Irish legislation). The first legal recognition of the Common Travel Area between Ireland and the UK is contained in the Treaty of Amsterdam. Agreements in relation to: reciprocal visa arrangements; measures to increase the security of the external Common Travel Area border; and the sharing of immigration data between the two countries' immigration authorities are already in place<sup>234</sup>. These measures, designed to preserve the integrity of the CTA, alongside existing EU law, custom and practice, could form the basis for future negotiations with the UK and the EU on the retention of the CTA.

However, the consequences of ending the CTA extend beyond those resident in either country; in recent years moves to facilitate movement of tourists and business visitors between both islands have progressed: the British-Irish Visa Scheme (BIVS) is a recent initiative to boost tourism and business visitors to Ireland by facilitating nationals requiring visas to travel freely between Ireland and the UK using a single visa issued by either country<sup>235</sup>. Such welfare and economic enhancing initiatives are now at risk.

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<sup>233</sup> The objective of the initiative is to ease the administrative burden on employers/connected persons/EEA contractors in expansion mode and to remove the requirement that they replicate the same employer/connected person information in respect of each employment permit application made for grant or renewal.

<sup>234</sup> In December 2011, the Irish and UK governments agreed a range of measures to secure the external border of the CTA – these include exchanging biographic and biometric visa data and co-operating on establishing information about failed asylum seekers.

<sup>235</sup> The British Irish Visa Scheme was introduced in 2014. It applies to visitors from China since 20 October 2014 and to visitors from India since 9 February 2015. This scheme allows visitors from these countries to travel freely within the Common Travel Area (using either an Irish or UK visa. Since July 2011, the Short Stay Visa Waiver Programme allows nationals of a number of Eastern European, Middle East and Asian countries who have a short-term UK visa to come to Ireland without the need for a separate Irish visa. This programme will end on 31 October 2016 when it is expected that the new British Irish Visa scheme will replace it.

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**Recommendation:** Maintain, to the extent possible, free movement of people between Ireland and the UK.

**Responsibility:** Department of Justice and Equality, Department of Jobs, Enterprise and Innovation, Irish Naturalisation and Immigration Service

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**Recommendation:** Develop, enhance and protect mechanisms that facilitate the movement of third country nationals between both countries.

**Responsibility:** Department of Justice and Equality, Department of Jobs, Enterprise and Innovation, Irish Naturalisation and Immigration Service

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In relation to energy policy, the extent of UK energy policy independence from EU law will determine the scale of policy response required – beyond the possibility of tariffs being introduced, and the risk that the UK will no longer be constrained by EU climate targets, in the longer term consideration of enhanced interconnection with mainland Europe may be required to mitigate risk and ensure energy security. Such considerations must form part of Ireland's longer term capital investment planning process.

Furthermore, the existence of Single Electricity Market (a combined market combining the Republic and Northern Ireland), poses challenges in light of Brexit and the future of wholesale electricity in Ireland is now under the microscope. At present, Northern Ireland is a separate market from the rest of the UK for electricity purposes.

Both the Irish and Northern Irish governments and regulatory authorities are currently engaged in a programme to integrate the UK, Irish and French electricity markets (the Integrated Single Electricity Market or I-SEM)<sup>236</sup>. This process is nearing completion and was expected to be completed by the end of 2017. A variety of market, regulatory, institutional issues arise depending on whether the UK Government decides to withdraw Northern Ireland from the I-SEM, or if it decides to maintain the I-SEM so that consumers in Northern Ireland can benefit from the larger all-island market

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**Recommendation:** Develop contingency plans to guarantee security of energy supply in Ireland. Such plans should be sufficiently flexible to respond to whatever degree of energy policy independence is obtained by the UK. In particular, contingency plans to develop greater interconnection with mainland Europe should be considered, with appropriate costings, funding models and delivery times all included in the plan.

**Responsibility:** Department of Communications, Climate Action and Environment, Department of Public Expenditure and Reform

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Finally, companies will ultimately be at the coalface of Brexit and will bear much of the fall out. As discussed, currency fluctuations (and subsequent changes in cost competitiveness) are likely to continue to pose the most immediate challenge for Irish exporters. In the medium term, however, Brexit is likely to present a host of changes impacting at firm level, including regulatory changes; the emergence of new customs and trade barriers; and potential changes to business models, supply changes and routes to market. These are in addition to the possibly long term structural shift

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236 I-SEM will essentially create a single set of markets (forward, day-ahead, intraday and balancing), and will cover both Ireland and Northern Ireland with a number of the key roles being carried out on an all-island basis by EirGrid (the transmission network operator).

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in the euro-Sterling exchange rate. Small and medium sized companies in particular will require support to overcome these obstacles.

Following the vote, Enterprise Ireland announced an initial series of actions designed to mitigate risk, and to ensure that Irish companies are in the best possible position to survive the challenges posed by Brexit, and to take advantage of the opportunities which emerge as a result<sup>237</sup>. The "Five Pillars of Enterprise Ireland Support" centre on:

- Information and Guidance;
- Market Diversification Support;
- International Sector Clustering Strategy;
- UK Market Support; and
- Competitiveness and Market Development Supports.

Enterprise Ireland through their new strategy for the period 2017-2020 will support companies to maintain and grow export in the UK and win business in other existing and new markets. Companies will be supported through a focus on competitiveness, innovation and market diversification supports.

In Budget 2017, the Department of Jobs, Enterprise and Innovation's capital budget was increased and the Department was granted approval for 50 plus posts to support industry following the UK vote to leave the EU. There will be a need for the Department to continually monitor the impact of the currency volatility and other issues to ensure the agencies are positioned to deliver the financial and soft supports needed through the negotiation period and following the formal exit of the UK from the European Union. Unlike other previous crises this is not cyclical but rather a structure change in the trading relationship between the UK and Ireland.

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**Recommendation:** Continue to closely monitor the impact of Brexit on companies in Ireland. Ensure that the Development Agencies have the required flexibility and are adequately resourced to deal with the implications – both the opportunities and challenges - of Brexit.

**Responsibility:** Department of Jobs, Enterprise and Innovation, Department of Agriculture, Food and the Marine

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<sup>237</sup> Enterprise Ireland, 5 Pillars of Enterprise Ireland Support: Information Guide for Irish Exporters to the UK, 2016; Enterprise Ireland, Exporting to the UK? A New Guide for Irish Business Post UK Referendum, 2016

## Chapter 10: Submission to the Action Plan for Jobs 2017

### Introduction

The Action Plan for Jobs represents an ambitious multi-year process that aims to deliver on the Taoiseach's commitment to make Ireland the best small country in the world in which to do business and is a key element of the Government's policy approach to rebuilding the economy and getting people back to work. Of particular note, is the commitment to implementation inherent in the APJ process. This is based on a structured monitoring regime which reports on a quarterly basis the actions that have, or have not, been delivered for that particular quarter.

The Action Plan for Jobs recognises the fundamental link between competitiveness and job creation, and is a key mechanism to drive competitiveness in all areas of economic activity. Previous Action Plans have provided a sharp focus on specific aspects of the competitiveness agenda, particularly in the area of costs, achieving a top-five international competitiveness ranking, and making Ireland the best small country in which to do business. A number of Council members (industry partners) also play an active role in promoting the implementation of key reforms.

The Council believes that the APJ process has been valuable from a competitiveness perspective and has been successful in driving coordinated actions to improve job creation, broaden the export and enterprise base, and enhance competitiveness. The APJ process should continue to evolve. The move towards a robust assessment framework with targets linked to specific actions and outcome-based performance indicators, as recommended by the OECD, should continue. In the medium term, it is important that a target-driven, whole-of-Government, quarterly monitoring and reporting framework is maintained.

The development of the APJ 2017 provides further opportunity to maintain this focus on competitiveness. Whereas the bulk of the Challenge report focuses on medium term actions, the Action Plan for Jobs focuses primarily on shorter-term, tangible actions (i.e. actions that can commence, or be delivered upon, over the next 12 months). The Council has, therefore, built on the analysis in the earlier chapters of this report to identify a range of prioritised short-term actions, which can build the foundations for our longer-term international competitiveness.

### A Renewed Focus on Competitiveness

As shown in *Ireland's Competitiveness Scorecard*, Ireland's international competitiveness has improved over recent years. While some of this reflects the significant policy reforms delivered through the series of Action Plans, and a range of other initiatives, external factors – low energy prices and the weak euro - are currently boosting Ireland's international cost competitiveness. While these factors are currently working in our favour, they can be quickly reversed, eroding the gains made to date. They also serve to shield us from some harsh truths: Ireland's continuing competitiveness is under threat, and there are indications that pressures are already emerging which are undermining our ability to compete internationally.

The Council is particularly concerned that as growth gathers pace, there are clear threats that could undermine the sustainability of Irish growth. In this regard, there is an urgent need for both the public and private sectors alike to manage proactively their cost base and drive efficiency, thus creating a virtuous circle between the costs of living, wage expectations, productivity and cost competitiveness.

The recent economic crisis demonstrated how international and national authorities were watching the wrong indicators and missed significant economic threats emerging. The risk now is that, having concentrated on improving Ireland's macroeconomic indicators; people will assume the hard work is done. The Council believes that competitiveness is integral to economic growth in the long run. Growth and jobs are essential to improving quality of life but to ensure that it is sustainable, we must keep our eye on competitiveness.



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Indeed, the same urgency and commitment that went into bringing down the government deficit, stabilising debt levels and securing the banking system must now go into maintaining and improving the competitiveness of the Irish economy. Our future wage rates, our ability to pay for the health service - let alone improve it - our ability to pay for good education for our children, our ability to have a generous state pension and our ability as an economy to survive in the Eurozone all depend on the competitiveness of the Irish economy. The challenge isn't over. In terms of maintaining competitiveness, it has only just begun.

## The Council's Priority Actions to Support Competitiveness in 2017

Based on the previous *Challenge* chapters, the Council has identified a number of actions which should commence in 2017. These are summarized below and reflect the nine broad thematic areas used throughout this report.

### Chapter 1: Balanced and Sustainable Growth

#### Delivering Balanced Growth: The Role of the National Planning Framework

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**Recommendation:** Publish the National Planning Framework and ensure that the principles of the NPF are subsequently reflected in the planned Mid-Term Review of the Capital Plan.

**Responsibility:** Department of Housing, Planning, Community and Local Government, Department of Public Expenditure and Reform

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#### Delivering a Low Carbon Economy and Minimising the Impact on Competitiveness

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**Recommendation:** Ensure that the baseline for Ireland's 2030 emissions targets accurately reflects Ireland's relative share of GDP per capita vis-à-vis other EU member states. This is of particular relevance given recent distortions in National Accounts data.

**Responsibility:** Department of Communications, Climate Action and Environment

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**Recommendation:** Take account of the environmental impact of individual projects – specifically on greenhouse gas emissions when prioritising investment as part of the Mid-Term Review of the Capital Plan. Particular recognition should be accorded to investments which simultaneously support competitiveness and contribute to Ireland meeting its greenhouse gas reduction targets.

**Responsibility:** Department of Public Expenditure and Reform

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**Recommendation:** Assess the potential Exchequer exposure should Ireland fail to meet its 2020 and 2030 targets for emissions reductions, renewable energy and energy efficiency as part of the National Mitigation Strategy.

**Responsibility:** Department of Public Expenditure and Reform, Department of Communications, Climate Action and Environment

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**Recommendation:** Consider the implications of allowing the indirect costs associated with the emissions trading system (ETS) to be reimbursed to participants. Clearly outline the opportunity cost of permitting reimbursement and highlight any implications for other aspects of carbon mitigation policy.

**Responsibility:** Department of Public Expenditure and Reform, Department of Communications, Climate Action and Environment

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## Energy Efficiency

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**Recommendation:** Expedite the publication of the first National Mitigation Strategy, and proceed rapidly to implement the agreed actions. Actions should be time bound with the clearly identified responsibilities and actors. The Plan should also include precise sub-sector targets.

**Responsibility:** Department of Communications, Climate Action and Environment, Department of Public Expenditure and Reform

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**Recommendation:** Evaluate the effectiveness of investments made to date through the National Energy Efficiency Fund, and on the basis that energy efficiency is the cheapest way to achieve GHG targets and because Ireland is not on track to achieve the 20 per cent energy efficiency target, determine whether another round of capital funding should be raised in 2016.

**Responsibility:** Department of Communications, Communications, Climate Action and Environment

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## Chapter 2: Fiscal Sustainability

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**Recommendation:** Develop a suite of national account measures that reflect actual real economic activity. This applies to both output and expenditure measures. Thereafter, work with Eurostat to improve their understanding of the issues which impact the Irish national accounts and ensure that EU calculations of economic activity reflect developments in the national accounts.

Continue the analysis to better understand the factors driving the national accounts results and to determine whether the changes in company accounting practices which are reflected in the national account results are a result of particular policy measures applied in Ireland or elsewhere.

**Responsibility:** Central Statistics Office

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## Expenditure

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**Recommendation:** Provide greater detail on the cost of all project spending proposals as part of the Mid-Term Review of the Capital Plan to ensure that public monies are spent in an efficient and effective manner.

**Responsibility:** Department of Public Expenditure and Reform, Irish Government Economic and Evaluation Service

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## Performance Budgeting

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**Recommendation:** Establish on a statutory basis the independent Irish Parliamentary Budget Office to ensure more parliamentary engagement in fiscal policy making and to assist in the overall goal of maintaining fiscal sustainability.

**Responsibility:** Department of Public Expenditure and Reform

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## Rainy Day Fund

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**Recommendation:** Develop detailed proposals and operational guidelines to facilitate the establishment of the ring-fenced "Rainy Day Fund" to serve as a counter cyclical buffer to economic and financial shocks.

**Responsibility:** Department of Finance, NTMA, Ireland Strategic Investment Fund

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## Taxation System

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**Recommendation:** Establish a tax committee to review, simplify, and bring coherence to Ireland's overall tax system over the medium term.

**Responsibility:** Department of Finance

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## Income Tax

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**Recommendation:** Outline how the revenue foregone from the abolition of the USC would be replaced in a growth and employment friendly manner, consistent with the principle of broadening the tax base.

**Responsibility:** Department of Finance, Tax Strategy Group

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## VAT

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**Recommendation:** Review VAT exemptions and outline the case for current reduced rates and exemptions. Consider the merits of further standardisation of rates to allow for reductions in more distortionary taxes such as those on labour.

**Responsibility:** Department of Finance

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## Property Taxes

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**Recommendation:** Expedite the revaluation of property prices in relation to the residential property tax.

**Responsibility:** Department of Finance

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## Environmental Taxes

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**Recommendation:** Consider the scope to make greater use of environmental taxes to reduce the tax burden on labour, to incentivise employment creation, and to help meet Ireland's environmental commitments.

**Responsibility:** Department of Finance

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## Chapter 3: Capital Investment in Physical Infrastructure

### Funding

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**Recommendation:** Increase the allocation for capital investment in physical and knowledge capital to support competitiveness, in the context of the Mid-Term Review of the Capital Plan. Ensure that coherent and clear linkages exist between the objectives set out in the National Planning Framework and the priorities identified in the Mid-Term Review of the Capital Plan.

**Responsibility:** Department of Public Expenditure and Reform

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**Recommendation:** Develop and source non-exchequer investment to support the delivery of economic infrastructure. Options include (i) Public-private partnerships; (ii) funding channels such as the European Strategic Investment Fund; and (iii) special purpose vehicles.

**Responsibility:** Department of Public Expenditure and Reform, Various public private sector bodies

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### Planning, Evaluation and Frameworks for Capital Investment delivery

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**Recommendation:** Review how other advanced economies coordinate and deliver capital investment and identify best practice in terms of the institutional framework for capital infrastructure investment.

**Responsibility:** Department of Public Expenditure and Reform, Irish Government Economic and Evaluation Service

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### Land Transport

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**Recommendation:** In the context of the Mid-Term Review of the Capital Plan examine the adequacy of the allocation for road infrastructure (in terms of the balance between expenditure on maintenance and upgrading, and new works). Ensure that the public transport component of the Mid-Term Review of the Capital Plan, and the development of the new National Planning Framework prioritise investment in a manner that is evidence-based and responds to the particular strategic opportunities present for all regions.

**Responsibility:** Department of Transport, Tourism, and Sport, Department of Public Expenditure and Reform

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**Recommendation:** The four identified priority projects in the Capital Plan should progress without delay (the M7 Nass-Newbridge widening project, the Sallins Bypass, the N59 Moycullen bypass outside Galway on the road to Sligo, and the Grange Castle Business Park works in west Dublin). Likewise, those projects referenced as essential by the Development Agencies should also be prioritised (N20 Limerick-Cork upgrade, N21 Limerick-Tralee upgrade, and sections of the N25 Cork-Waterford road and completing the Galway city Outer Bypass).

**Responsibility:** National Transport Authority

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**Recommendation:** Identify key priority actions and timeframes for delivery under the National Transport Authority's Transport Strategy and Implementation Plan for the Greater Dublin Area 2016 – 2035.

**Responsibility:** National Transport Authority

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### Energy

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**Recommendation:** Develop a target led, time bound implementation plan around the priorities identified in the Energy White Paper.

**Responsibility:** Department of Communications, Climate Action and Environment

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**Recommendation:** Review the legal and institutional framework for the regulation of electricity and natural gas markets including the CER's mandate and resourcing in line with the Government's Energy White Paper.

**Responsibility:** Department of Communications, Climate Action and Environment

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**Recommendation:** Assess the issues that may arise for energy supply, security and costs under the different scenarios envisaged in the pre-negotiation phase of Brexit.

**Responsibility:** Department of Communications, Climate Action and Environment

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**Recommendation:** Complete cost-benefit analysis for Smart Metering and consult with enterprise to determine the optimal scale, scope and timing of the roll-out of smart metering in Ireland.

**Responsibility:** Commission for Energy Regulation

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### Telecommunications

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**Recommendation:** Identify specific barriers and recommend actions to improve mobile and broadband access pending the rollout of the National Broadband Plan

**Responsibility:** Mobile Phone and Broadband Taskforce

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**Recommendation:** Award the National Broadband Plan intervention to a contractor(s) and confirm the revised deployment schedule to ensure the timely rollout of the Plan. Ensure that the network is scalable and proofed to meet future demand for significantly higher download speeds (in excess of 100Mbps) and higher upload speeds.

**Responsibility:** Department of Communications, Climate Action and Environment

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**Recommendation:** Commence work on the successor to the National Digital Strategy.

**Responsibility:** Government, Department of Communications, Climate Action and Environment

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### Water and wastewater services

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**Recommendation:** Develop a clear plan that provides certainty with regard to the future funding of public water and wastewater services in Ireland. It must deliver an adequate funding stream, facilitate investment, meet EU objectives in terms of the user pays principle, and must avoid cross subsidisation.

**Responsibility:** Government, Department of Housing, Planning, Community and Local Government

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## Chapter 4: Improving Cost Competitiveness

### Property: Residential Property

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**Recommendation:** Devise a clear implementation plan for *Rebuilding Ireland – Action Plan for Housing and Homelessness* with specific timelines and assigned responsibility for specific actions. Drive implementation through regular reporting and cross-agency collaboration. Establish and resource the Housing Delivery Office and the Housing Agency's dedicated Procurement Unit as a matter of urgency.

**Responsibility:** Department of Housing, Planning, Community and Local Government

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**Recommendation:** Establish the State Lands Management Group with the clear objective of improving the supply of affordable development land. Drive proactive engagement with all relevant interests on the large-scale strategic sites to accelerate the delivery of new homes in our urban areas.

**Responsibility:** Department of Housing, Planning, Community and Local Government

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**Recommendation:** Launch the competition to develop innovative systems for the delivery of affordable high quality residential development. Analyse the cost savings and disseminate the learnings from the competition to housing stakeholders.

**Responsibility:** Department of Housing, Planning, Community and Local Government

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**Recommendation:** Develop and publish a strategy for the rental sector by the end of 2016.

**Responsibility:** Department of Housing, Planning, Community and Local Government, Residential Tenancies Board

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**Property: Commercial Property**

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**Recommendation:** Expedite the development of a commercial property price register encompassing data on commercial sales and leases.

**Responsibility:** Central Statistics Office, NAMA, Central Bank

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**Business Services: Legal Services**

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**Recommendation:** Continue to develop a more comprehensive and representative data set on legal service prices.

**Responsibility:** Central Statistics Office, Legal Profession

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**Recommendation:** Incorporate the competition-enhancing and cost-reducing provisions of the Legal Services Act rapidly into the regulations to be issued by the independent Legal Services Regulatory Authority. Ensure that the LSRA is adequately resourced to undertake the research necessary to fulfil its mandate.

**Responsibility:** Department of Justice and Equality

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**Recommendation:** Continue to modernise the legal service profession. The establishment of a specialist conveyancing profession and the creation of a single tier counsel system should be considered in this regard.

**Responsibility:** Department of Justice and Equality, Legal Services Regulatory Authority

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**Recommendation:** Monitor the impact of recent changes to the Rules of the Superior Courts which are intended to drive court efficiencies. Ensure that the application of the new rules has a positive impact on court efficiency without adverse consequences on costs. Provide the necessary resources to the judiciary to enable them to perform any additional administrative functions arising from application of the new rules.

**Responsibility:** Department of Justice and Equality, Courts Service

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**Recommendation:** Extend the rollout of ICT to courts of higher instance.

Review the outstanding procedural reforms recommended by the Legal Cost Working Group and implement those which remain relevant and feasible, making reference to the findings of the OECD. Consideration should also be given to the role that models such as alternate dispute resolution can play in reducing costs.

**Responsibility:** Department of Justice and Equality, Courts Service

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**Insurance**

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**Recommendation:** Publish the findings of the Review of Policy in the Insurance Sector. Devise a clear implementation plan for addressing issues regarding data availability and the factors driving up insurance costs. The plan should have specific timelines, reporting mechanisms and assigned responsibility.

**Responsibility:** Department of Finance

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### Finance for Growth

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**Recommendation:** Develop an appropriate regulatory framework for the crowdfunding market (including peer-to-peer lending) to enhance consumer confidence and encourage increased lending activity.

**Responsibility:** Central Bank, Department of Finance, SME State Bodies Group

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**Recommendation:** Introduce the Central Credit Register for personal borrowers as planned and confirm the timeframe for the commencement of the business-relevant phase of the Register.

**Responsibility:** Central Bank

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**Recommendation:** Consider the development of an online cost of finance comparison tool for SMEs that will enable companies to quickly and reliably compare banks and banking products (in terms of price, quality of service and lending criteria) across the whole range of providers.

**Responsibility:** SME State Bodies Group

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## Chapter 5: Enhancing Talent and Skills

### Funding Higher Education

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**Recommendation:** Develop and implement a funding model that allows for increased participation and quality in higher education. The funding model should reflect the principles outlined by the Expert Group on Future Funding for Higher Education in relation to certainty and consistency; meeting national ambitions; supporting an increase in quality; enhancing access and participation; and ensuring fairness and balance.

**Responsibility:** Department of Education and Skills, Higher Education Authority

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### Lifelong Learning

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**Recommendation:** Prioritise actions to increase participation in formal learning, with a particular focus on engaging low skilled workers. As well as making it easier to participate in lifelong learning, there is a need to communicate the benefits and returns which accrue through participation to potential learners and to employers.

**Responsibility:** Department of Education and Skills, Higher Education Institutions, Education and Training Boards, private education and training providers, employers

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**Recommendation:** Complete and publish the Foreign Languages in Education Strategy in Q4 2016. The Strategy should be developed with a 5-10 year vision to provide an integrated and coherent approach to foreign language teaching in all learning contexts. Establish the language advisory group to drive implementation in Q1 2017 as outlined in the Action Plan for Education.

**Responsibility:** Department of Education and Skills

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**Recommendation:** Reform the funding model for Higher Education to support the growth ambitions and the capacity to meet specific targets on identified skill gaps in areas such as ICT, data analytics, sales and foreign language skills, in the context of the Higher Education System Performance Framework 2017-2019.

**Responsibility:** Higher Education Authority

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## Chapter 6: Fostering Productivity Growth

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**Recommendation:** Review the effectiveness of the Global Sourcing Initiative. Strengthen and intensify linkages between indigenous and multinational enterprises. This includes active engagement by the enterprise agencies to assist suitable indigenous companies to optimise supply chain business opportunities.

**Responsibility:** Department of Jobs, Enterprise and innovation, IDA Ireland, Enterprise Ireland

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### Deepening Innovation Capacity, Capability and Activity at Firm Level

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**Recommendation:** Develop a strategy for increasing awareness of the benefits from participation in productivity enhancing programmes such as Lean.

**Responsibility:** Enterprise Ireland

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**Recommendation:** Build upon the Review of Enterprise Supports for Research, Development and Innovation, which is currently being undertaken by DJEI, to ensure that the needs of all companies engaging in research and innovation are being met.

**Responsibility:** Department of Jobs, Enterprise and innovation, Enterprise Agencies

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### Irish Productivity Data

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**Recommendation:** Develop detailed metrics to measure productivity performance at sectoral level.

**Responsibility:** CSO, Department of Finance, Department of Jobs, Enterprise and Innovation

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### Public Sector Productivity

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**Recommendation:** Develop metrics for public sector productivity levels and services.

**Responsibility:** Department of Public Expenditure and Reform

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## Chapter 7: Broadening the Enterprise and Export Base

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### Internationalisation and Market Diversification

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**Recommendation:** Publish a successor to the *Trading and Investing in a Smart Economy – A Strategy and Action Plan for Irish Trade, Tourism and Investment to 2015* to assist the further internationalisation of Irish exporters, increase market diversification, and support investment. An increased focus on sectors of competitive advantage as identified in the Action Plan for Jobs process is required and their alignment with specific target markets.

**Responsibility:** Department of Foreign Affairs & Trade, Department of Jobs, Enterprise & Innovation, Department of Agriculture, Food & Marine, Department of Transport, Tourism and Sport, Department of Education & Skills, State Agencies

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### Indigenous Exporting Base

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**Recommendation:** Continue to ensure an uplift in the number of market-ready firms internationalising and continue to work with targeted client companies to increase their internationalising capabilities

**Responsibility:** Enterprise Ireland

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**Recommendation:** Publish an ambitious medium term strategy for the Local Enterprise Offices to achieve a step-up in small business performance as committed to in APJ 2016

**Responsibility:** Department of Jobs, Enterprise and Innovation

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### Supporting Innovation amongst Agency Clients

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**Recommendation:** Strengthen and develop enterprise innovation activity including collaboration and partnership with the public research system, with particular focus on firms that have not previously engaged in such collaboration.

**Responsibility:** Department of Jobs, Enterprise and innovation, Enterprise Agencies

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**Recommendation:** Undertake a market-led horizon scanning to identify strategic areas of commercial opportunity in global markets for Irish-based enterprises as the basis for the next cycle of research prioritisation

**Responsibility:** Department of Jobs, Enterprise & Innovation

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## Chapter 8: Increasing Labour Market Participation

### Social Welfare and Replacement Rates

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**Recommendation:** Complete the rollout of the Housing Assistance Payment. Monitor and evaluate its impact on replacement rates and on the likelihood of recipients transitioning into the labour market. All housing assistance payments should depend on income rather than employment status.

**Responsibility:** Department of Social Protection

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**Recommendation:** Further develop the concept of the Working Family Payment, outlining how it differs from existing payments and schemes (E.g. Family Income Supplement, Back-to-Work Family Dividend), and the expected impact of such a payment on family income and labour market outcomes.

**Responsibility:** Department of Social Protection

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### Labour Market Activation

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**Recommendation:** Replace JobBridge with a reformed internship programme which delivers increased opportunity for interns to progress to employment within the host organisation, with a particular focus on low skilled, youth unemployment and long term unemployment.

**Responsibility:** Department of Social Protection, SOLAS

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### Childcare Costs and Labour Market Participation

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**Recommendation:** Undertake an independent review of the cost of providing quality childcare in private and community settings, consistent with the principle of ongoing professionalisation of the sector.

**Responsibility:** Department of Children and Youth Affairs

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**Recommendation:** Publish a detailed implementation plan to cover all aspects of the Single Affordable Childcare Scheme. Ensure that the additional administrative and regulatory implications of the Scheme are addressed in a manner that facilitates the rapid and efficient rollout of affordable childcare to working families.

**Responsibility:** Department of Children and Youth Affairs

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## Chapter 9: Brexit and Irish Competitiveness

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**Recommendation:** Undertake a benchmarking exercise comparing Ireland's performance across a range of key competitiveness metrics with the UK and Northern Ireland.

**Responsibility:** National Competitiveness Council

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**Recommendation:** Continue to closely monitor the impact of Brexit on companies in Ireland. Ensure that the Development Agencies have the required flexibility and are adequately resourced to deal with the implications – both the opportunities and challenges – of Brexit.

**Responsibility:** Department of Jobs, Enterprise and Innovation, Department of Agriculture, Food and the Marine

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