Measures to address the immediate economic implications of Brexit

November 2016

Overview

Since the Brexit referendum result Sterling has fallen by 18% against the Euro. It has fallen by 23% since last Christmas. There are a number of competing narratives regarding the fall in the value of Sterling. What is clear is that Brexit has damaged faith in the future of the UK economy. The truth, in either case, is not particularly reassuring for Ireland. This fall in Sterling will both increase the cost of Irish goods going into the UK and mean increased competition on Irish shelves from British products. It will damage tourism flows from the UK and drive retail activity of Irish consumers cross-border and online.

Two weeks after the Brexit result, Ibec conducted a survey of over 450 Irish CEOs. Of twelve potential options exchange rate volatility was identified as the key immediate challenge; it was a top three concern for 60% of firms. Within this, indigenous firms were much more worried about Sterling than multinationals. Indigenous firms, however, only account for around 11% of Irish exports and less than 15% of our exports go to the UK. As such total Irish exports may still experience growth to the EU, US and elsewhere. It would be easy to underestimate the economic importance if you didn't examine the detail.

Indigenous exporters spend as much in the domestic economy through purchases and wages as the multinational exporters. They also employ as many people, with even greater regional spread. These indigenous exporters are also much more reliant on the UK. Over 40% of their output goes to the UK, compared with only 10% of that from non-Irish companies. The impact of Brexit on the producers of 11% of our overall exports will be as important for the domestic economy as the fortunes of the producers of the other 89%.

In addition, sectors such as tourism and retail which are our largest regional employers will face significant challenges. Retailers in counties near the border will face the prospect of losing a significant amount of customers over the Border this Christmas. In addition, increased online purchases from UK stores will be driven by the weak Sterling. This activity will take key consumer demand out of our towns and cities and cost jobs across the country.

We have been here before. In the late 80's and early 90's teh exchange rate went over 90p on a number of occasions. During the financial crisis we again saw exchange rates reach those levels. This time is different, however. Previous bouts of Sterling weakness were cyclical; these recent changes represent a structural change in the strength of the currency. Depending on the political machinations in London a weak Sterling may be the new normal facing Irish business. Indeed, if the UK continues toward a 'hard Brexit' then Euro/Sterling will climb toward parity over the coming years.

Falls in our exports, tourism or an increase in cross-border shopping (online or physical) will cost jobs. The potential loss of single market status from the UK will only intensify the existing currency pressures. It is vital the government reflect on its priorities in that context. Measures in the recent budget were a start in addressing the Brexit challenge, but did not go near far enough. This document outlines the immediate response which Ibec believes the Government must take in order to avoid significant Brexit related business and job losses in 2017.

Priority 1: Mitigation and diversification package for impacted industries

Challenge: There are a number of ways in which the market for Irish exporters has changed since the last sustained period of similar Sterling exchange rates in 2010. In the first instance, margins in Irish industry are much tighter than in 2010, in addition the potential to reduce costs in the industry is much more constrained with most companies having gone through significant restructuring during the last decade.

In addition to the constraints on both retailers' and manufacturers' ability to internally adjust in the face of a weak Sterling their ability to pass through price in Ireland or the UK is now significantly weaker than in 2010 given both the income effects in the UK and the fact that trade growth in recent years has been built on lower unit prices.

Given the difficulty for most businesses to achieve prices increases in the UK it is imperative that efforts are made to support companies to mitigate losses and retain UK market share and to diversify

Priority actions:

- **Enterprise stablisiation fund -** Ibec believes Ireland's extreme exposure to both Sterling's depreciation and the threat of hard Brexit warrants the re-introduction of the Enterprise Stablisiation measures which were last applied in 2009-11 or a similar scheme. As such the government must begin work at a European level to adopt a temporary framework for state aid (in line with that introduced at a European level in 2008) in recognition of Irish industry special case with regards Brexit.

- **State Aid rules:** As in 2009 a temporary framework for State Aid will be needed at a European level in order to offset the worst impacts of Brexit on otherwise viable firms. The government must begin now to work with European partners in order to achieve this. The current rescue and restructuring state aid rules are designed to rescue large strategic industries which have already gone through liquidation. This will be of limited use to enable viable Irish business diversify and restructure. Intensity ratios in regional aid guidelines may also need to be re-examined given the significant regional impacts of Brexit.

- **Additional funding for market diversification and innovation measures -** In the past, the UK has been the first port of call for Irish companies. This market will now be much more difficult to enter for new exporters. A market diversification and product innovation strategy with particular focus on maintaining U.K. Market share, increasing exports to other EU and international markets and investing more in product development will need to be introduced.

- **An access to finance package that includes sustainable financing via funding from the Irish Strategic Investment Fund (ISIF) -** Irish firms pay a greater premium on funding compared to their EU counterparts. That premium is already two percentage points on funds borrowed. The work of ISIF and other funders in providing access to appropriate finance measures will have to be accelerated.

- **Trade finance measures -** Ireland is one of only two countries in the EU without a state back support for export credit. This can often be an important way of mitigating the risk for firms who are looking to diversify into new and riskier markets. This along with a broader suite of trade finance measures must be at the center of Ireland's diversification strategy.

- **Online trading supports -** Growth in online trade to the UK is inevitable due to the weaker Sterling. This can only be mitigated by dramatically growing the share of Irish based business in the online spend of Irish customers. The online trading voucher should be expanded to a greater cohort of Irish retail SMEs (up to 50 employees) which are not currently online.

Priority 2: Cost Competitiveness in the context of Brexit

Challenge:

Firms most affected by Sterling depreciation are those in food and services where the majority of exports go to the UK. Over the coming years it is likely that Sterling will continue to weaken and the euro/sterling exchange rate will remain elevated with the economic situation in the UK expected to deteriorate.

This will not just affect exporters. This fall in Sterling will also mean increased competition on Irish shelves from British products. It will damage tourism flows from the UK and drive retail activity of Irish consumer's cross-border and online. This will have the double effect of damaging three of our most employment intensive industries – agrifood and drink, retail and tourism. Urgent action is now required to protect our vital exports to the UK market, limit damage in the domestic market from cross-border shopping, and address competitive pressures caused by the fall in Sterling.

A further impact of the euro/sterling exchange rate is also the enhanced competitive position of certain UK exports which come into direct competition with Irish exports in other euro zone countries.

Priority actions:

An intense ongoing – whole of government - focus on cost competitiveness in areas such as labour costs and the minimum wage, on policy decisions that would adversely impact PSO charges on electricity; and on insurance costs

- **Labour costs –** A strong focus on labour cost competitiveness needs to be maintained in the context of Brexit. Irish exporters selling into the UK have already seen margins disappear as a result of fluctuations in Sterling. The income effect on UK households will also hurt many of our most cost sensitive industries such as agrifood and drink and tourism. Issues such as further increases to the minimum wage, erosion of flexible labour market policy and imposition of further taxes on employment must be addressed in this context.

- **Insurance costs** – Government is now taking action to address the spiralling cost of motor insurance. However, attention also needs to be paid to public liability and employer liability insurance. Typically, these equate to nearly three percent of a company's payroll cost. There are worrying signs that premiums are set to increase sharply. Personal injury awards tend to be far higher in Ireland than elsewhere in the EU. Rising legal costs further add to the burden.

- **The PSO Levy –** The Levy helps Ireland to meet EU-mandated renewable energy targets by supporting investment in clean electricity generation projects that would otherwise not be bankable. However, Irish industry's share of the financial burden is substantially higher than it ought to be. The Commission for Energy Regulation needs to correct this.

  The Government in turn needs to ensure that any new renewable support schemes are cost-effective. It does not make economic sense to subsidise mature premium cost technologies such as offshore wind on a large scale. For other emerging technologies, including solar PV, the underlying costs are still poorly understood. In such cases, it may be necessary to hold competitive auctions instead of offering fixed feed-in tariffs.

- **Regulatory costs –** The government must ensure that further plans to impose regulatory burden are not imposed on Irish business. This includes regulatory costs such as structural separation in retail stores, taxes on sugar sweetened drinks and those recently announced in the medical devices industry. In the light of the opportunities in the financial services sector it must ensure the quality, consistency and efficiency of financial regulation is world class. We must take steps to minimise regulatory divergence. We must be more active in influencing

European regulatory policy but also monitor and respond nationally to any changes the UK makes. Government must liaise with our exporting and domestic sectors on complex regulatory issues.

Priority 3: Equalisation of taxation with the UK

Challenge:

Helping those sectors most effected by Brexit maintain a competitive edge will be an important factor in overcoming the challenges that Brexit will pose. Potential trade restrictions post Brexit and the more preferable tax treatment of SMEs in the UK raise the possibility of Irish SMEs servicing that market from within the UK itself rather than by exporting from Ireland. As such, the need to level the playing field in relation to the tax offering for indigenous business has never been more urgent. While changes in the recent budget were welcome they did not go far enough.

Priority actions:

- **CGT entrepreneurs' relief –** The UK market is an important one for Irish SMEs across a number of sectors and for many is their main growth market. The prospect of trade restrictions post Brexit and the preferable tax treatment, mean it will become more attractive for many Irish-based SMEs to expand and service that growth market from within the UK rather than by exporting from Ireland. Changes to the CGT entrepreneur's relief in Budget 2017 provided some boost for growing SMEs but they did not go far enough leaving effective rates more than 15 percentage points higher than for their UK counterparts.

- **The taxation of stock options -** In line with our recent submission to the consultation on the taxation on stock options, Ibec has a number of recommendations:
    - Reform of the operational constraints in revenue-approved schemes to be more flexible to companies' reward structures.
    - Reduction of the income tax liability on unapproved schemes to the ordinary rate of tax along with averaging it out over five years.
    - Removal of the USC and PRSI liability from revenue-approved schemes.
    - Introduction of an enterprise management incentive scheme for smaller firms

- **Taxation of the self-employed** - The lack of an equivalent earned income tax credit (EITC) for the self-employed is not supported on any reasonable basis. The Government should complete the rectification of this situation in Budget 2018.

- **The R&D tax credit and SMEs -** The administrative costs associated with the R&D tax credit are too burdensome for smaller firms to participate with the credit. A pro-forma R&D tax credit should be introduced to help smaller firms overcome these costs and engage with the credit.

- **Personal tax rates –** Personal tax rates for high skilled workers in Ireland are significantly higher than in the UK. Ireland has the highest marginal effective tax rate (METR) for both average and median earners in the EU at 50.6%. This means that for an average earner the effect of our tax and benefit system will reduce any pay increase they receive by over half. This is over 15 percentage points higher than for a similar worker in the UK. In addition, when compared with workers in the UK more Irish employees face these high METRs. Only 12.4% of UK workers face losing more than 50c from a €1 pay increase; the same figure in Ireland is 39%.

  One of our opportunities in a post-Brexit world will be to attract additional high skilled jobs in financial services or broader FDI. This will be severely curtailed by our income tax system which is now an outlier in the developed world.

Priority 4: Liveability, high skilled workers & education

The opportunity:

Making Ireland a better place to live and work is crucial in a post Brexit environment. Whatever upside is available to Ireland from capital flight as a result of Brexit will not be full realised in the absence of concrete action to tackle liveability issues such as housing and childcare. Indeed if significant investment in our major cities is not forthcoming then any Brexit benefits will quickly exacerbate existing shortages in housing and infrastructure capacity.

Priority actions:

- **Housing** - Ireland needs between 35,000 to 40,000 new homes each year to meet demand. Property Industry Ireland's recent Property Watch report predicts a completion rate of only 11,000 new homes in 2016, of which around a third will be self-build houses which are not intended for the market. Housing is now among the top labour market issues employers are facing and is posing a serious challenge to our competitiveness. At a fundamental level we need to reform how we deliver social and affordable housing in Ireland.

- **Childcare** - Ireland needs to have the social infrastructure in place to ensure that work pays for individuals. Ireland's childcare costs reduce the incentives for parents entering the workforce. They are amongst the highest in the OECD, accounting for 53.5% of the average wage in Ireland, compared to an average of 27.6% in other OECD countries. This is largely because in other countries, childcare costs are heavily subsidised by the state. Once children are then of school going age, not only is affordability an issue but availability is one too as there is a limited range of after-school services which cater for working parents. The OECD has acknowledged that Ireland has one of the highest overall levels of benefits (cash and services) for parents of any EU country. However, the current use of these funds is poorly targeted, as payments are universal and are not means tested.

- **Education funding** It is a simple fact that high skilled workers will not move to Ireland's urban areas post-Brexit unless there is appropriate places and supports in the education system; particularly in this context funding for schools is needed where the international baccalaureate is available. A wider solution to higher education funding is also required in order to strengthen Ireland's international reputation and underpin a strong supply of quality high-skilled talent.

Issue 5: Support for the regions

Challenge:

Ireland is already one of the most economically imbalanced countries in the EU with the Dublin area producing over 40% of value added. This compares unfavourably with almost every other small European nation. The risks from Brexit will weigh heavily on the regions. On the other hand Dublin in particular is presented with some opportunity. Regional imbalance will get much worse due to Brexit unless Government takes targeted measures.

Priority actions:

- **The capital budget -** During previous slowdowns, the first budget item to lose out was the capital budget. Ireland's experience both in the early 1990s and in recent years is that the cyclicality of our investment spending only exacerbates downturns and stores up major infrastructure shortages for the recovery. The consequences of these mistakes are clear in our housing and key infrastructure – they should not be repeated. Even with the welcome additional expenditure flagged in the programme for government, the Exchequer contribution to the new capital plan will be the smallest on record proportional to the size of the economy. Ireland is facing into rapid demographic growth and overheating pressures in transport, education, water, broadband, health and other public infrastructure which are affecting Ireland's competitiveness.

- **Regional balance -** Ireland now has good road connections between Dublin and most of the regions (the exception being the North West). However, in the interests of balanced regional development we need to improve the radial links between our secondary cities. The road between Cork and Limerick is a particular case in point. We also need to improve the feeder roads to some of our ports and to expedite public transport initiatives in our capital.

- **Regional taskforces** – Regions will face different challenges from Brexit. For the West it will be the threat to tourism, the threat to agribusiness in the South and the border counties face a potential vacuum effect for consumer activity. In this context the establishment of regional taskforces on Brexit, through the existing regional action plan for jobs structures, would be a worthwhile exercise in establishing the opportunities and challenges for the regions to the impacts of both Sterling and longer term trade disruptions.

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