ESRI ECONOMIC & SOCIAL RESEARCH INSTITUTE

Submission to the Department of Enterprise, Trade and Employment

Public Consultation on the Preparation of the White Paper on Enterprise

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Introduction

1. This submission from the Economic and Social Research Institute (ESRI) contributes evidence-based views for consideration by the Department of Enterprise, Trade and Employment for the development of the future strategic direction of Enterprise Policy in response to challenges, opportunities and new drivers for growth faced by Ireland's enterprise sector. The submission draws on previous ESRI research across the relevant consultation questions.

2. The challenges faced by the Irish economy and Ireland's enterprises in the context of long-term global trends and international policy developments require **a coherent strategic direction and strengthened policy co-ordination** across government departments and agencies. International and Irish evidence suggest that the policy mix to address these challenges should combine **horizontal (untargeted) policies shaping the business environment** (such as competition and trade policies) **and targeted policies** at the intersection of incentives for business investment, the transition to the green economy, digital transformation, financial incentives for R&D and innovation, supply chain linkages between small and medium-sized enterprises (SMEs) and multinational enterprises (MNEs), skills upgrading programmes, entrepreneurship, and regional development (Cantillon et al. 2022; Criscuolo et al. 2022; Kakoulidou and Roantree 2021; Lawless 2014; Siedschlag and Yan 2021; Siedschlag et al. 2022). The policy mix should be evaluated for effectiveness on a regular basis (Criscuolo et al. 2022; Ruane and Siedschlag 2013).

Enhancing the Productivity of Indigenous Firms and the Challenge of Digitalisation

3. **Enhancing productivity** is the driver of long-term economic growth and development. While on an aggregate basis, Irish productivity indicators (in particular labour productivity) have bucked the international trend of declining productivity, there is a growing recognition that these features of the Irish economy are driven by a small number of large, highly productive multinational firms (National Competitiveness and Productivity Council, 2021; Papa, 2019) and that many Irish domestic firms have considerably lower productivity levels. Indeed, the OECD (2020) notes that Ireland has a long tail of low productivity SMEs and this is driven in part by the continued usage of low-productivity techniques, management practises which require improvement and investment gaps in the area of digitalisation.

4. This evidence suggests that **a critical driver of productivity growth for SMEs, in particular laggard SMEs, will be investing in new and better technologies and bridging the digital divide**. Recent research has shown that typically about two-in-every-three SMEs invest each year (when focusing on a broad investment category of machinery, equipment, vehicles, intangibles, staff and buildings) with a large share of firms noting they are happy with their existing capacity (Cantillon et al., 2022). Furthermore, Cantillon et al. (2022) also show that only one-in-three enterprises invested in digital

activities. Ensuring such SMEs have the scope and ambition to capitalise on opportunities and invest in new technologies is going to be critical to address the productivity gap. Numerous studies have indicated that both financial and non-financial factors matter for SME investment (Lawless et al., 2021; Gargan et al., 2018). **Therefore the policy platform to spur investment will likely need to facilitate lending supports** (such as long term, low cost loan facilities) **as well as other enablers such as management training to attempt to bridge the investment gap**.

Enabling and Fostering Firm Dynamism and Business Investment

5. **The establishment and growth of new businesses are key ingredients for economic growth** and young firms are disproportionate creators of new jobs (Lawless, 2014). The rate of business entry and exit dynamism is particularly low in Ireland. OECD evidence shows that Ireland has one of the lowest shares of start-ups in the business economy and also a low share of employment relative to other developed countries (OECD, 2018). **Encouraging and supporting a continuing flow of new enterprise start-ups should therefore be a central plank of enterprise policy**. From a policy perspective, it is important to recognise that the appropriate strategies may be quite different for the establishment and first employment stages of a firm's development relative to those suitable for more established firms, with a stronger case for enterprise policies aimed at encouraging investment in and by new businesses.

6. While some aspects of enterprise policy are well targeted at encouraging investment in and by new businesses (e.g. the Employment Incentive and Investment Scheme), many others are not. Kakoulidou and Roantree (2021) highlight Capital Gains Tax Retirement Relief and Entrepreneur Relief as two examples of poorly targeted tax expenditures with a questionable underlying economic rationale, pointing to international research that shows similar reliefs are more likely to generate efforts to minimise tax on retirement than their stated purpose of spurring entrepreneurship or investment.

7. Rather, if the policy objective is to encourage investment in and by new businesses, there is a good case for **refocusing the array of existing tax expenditures away from reduced rates of Capital Gains Tax on the disposal of certain business assets and towards tax relief on investments into new firms**. For example, Adam and Miller (2021) propose eliminating reduced rates of Capital Gains Tax alongside the introduction of a new investment vehicle offering up-front income tax relief on investments made to purchase new equity issued by companies, with tax instead paid when funds are withdrawn: akin to the treatment of pensions saving. Such an approach would support business owners making new investments in proportion to the amount they invest and at the point of investment, instead of – as under the current system – to those whose investments pay off most when they dispose of eligible assets.

Challenges and Opportunities Arising from the Transition to a Low-Carbon Economy

8. International evidence suggests that **the transition to a climate-neutral economy and a more sustainable long-term economic growth require enterprises to accelerate their investments in low-carbon technologies** (Acemoglu et al. 2012; Costantini et al. 2013; Voigt et al. 2014; Ghisetti and Quatraro 2017). Recent research finds that the proportion of firms with green investments in Ireland is low (Siedschlag and Yan 2021). This research also shows that larger enterprises are more likely to invest in equipment for environmental protection and cleaner technologies. To the extent that incentivising more firms to invest in environmental protection could contribute to a faster transition to a more sustainable long-term growth, this research suggests that **targeted policy measures to enable small and medium-sized firms to invest in environmental protection would be beneficial to achieving that goal**.

9. Skills gaps have been identified as a major obstacle in emerging sectors closely linked to the transition to a low-carbon economy (CEDEFOB 2018, OECD 2017). Recent ESRI research (Siedschlag et al. 2022) finds that **developing new skills within the enterprise workforce is the top challenge** from the implementation of Ireland's Climate Action Plan enterprises face in the medium-term. The results of this research suggest **that tailored training programmes to each sector and enterprise group and at different stages in the transition to a low-carbon economy** would help businesses to better act and manage the transition to a low-carbon economy.

10. International evidence indicates that **access to digital skills is a key factor for enabling and maximising enterprises' capacity to innovate and to support their transition to a low-carbon economy in all sectors** (EIB 2021). Recent evidence from Ireland and other European countries shows that the demand for digital skills in the enterprise sector is not sufficiently met (Eurostat, 2021).

11**. Managers' awareness of issues relating to environmental quality and leadership skills to enable green transformations** have been identified as being among the most important skills to facilitate an enterprise transition to a low-carbon economy (Singh et al. 2020).

Enhancing Supply Chain Linkages between SMEs and MNEs

12. International evidence indicates that **supply chain linkages between domestic and foreign-owned firms could be an important source of technology transfer** (Javorcik 2004; Havranek and Irsova 2011; Jude 2016). Having strong supply chain linkages between domestic and foreign affiliates also contributes to embedding multinationals into the domestic economy and reducing the likelihood that they leave (OECD 2013).

13. Evidence from Ireland shows that the **productivity of domestic firms in upstream industries is positively linked to supplies to foreign-owned firms** (Barrios et al. 2011; Di Ubaldo et al. 2018). Further evidence indicates that **supply chain linkages with foreign affiliates of multinational enterprises help local firms to diversify their exports and imports** (Di Ubaldo and Siedschlag 2022).

14. **The absorptive capacity of domestic firms is key to benefiting from such spillovers from MNEs.** R&D activity appears to be of particular relevance for absorbing knowledge from foreign affiliates upstream of local firms and for using it to diversify trade activities (Di Ubaldo and Siedschlag 2022). **Targeted policies at the intersection of cluster policies, skills upgrading programmes, financial incentives for R&D and innovation could enhance the absorptive capacity of SMEs and maximise their benefits from supply chain linkages with MNEs.**

15. Recent international evidence indicates that foreign affiliates in Ireland source less inputs from domestic firms relative to the average for the OECD (OECD 2021). **Developing and updating local suppliers databases** could help foreign affiliates to identify local suppliers targeting traditional SMEs as well as young innovative start-ups.

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