

RISING DOMESTIC COSTS ALLIED TO EXCHANGE RATE EXPOSURE THREATENS SUSTAINABLE RECOVERY

National Competitiveness Council publishes *Costs of Doing Business in Ireland 2016* report

The National Competitiveness Council (NCC) today launched its *Costs of Doing Business in Ireland 2016* report. This report benchmarks the main business costs across over 50 indicators and focuses on areas where Irish enterprise costs are out of line in those in key competitor countries. The report concentrates on costs that are largely domestically determined such as labour, property, energy, water, waste, communications and business services, and considers both price levels, and changes in those levels (i.e. price inflation).

The improved competitiveness of Ireland's exporting sector has been one of Ireland's greatest strengths in recent years and has been key to economic growth and job creation. It has been critical to the success of Irish based exporters, allowing them to maximise the opportunities arising from increases in global demand.

Despite improvements in Irish cost competitiveness since the global economic and financial crisis, threats to continued economic success abound. While the Irish economy is experiencing rapid growth, the global economy is not proving as robust, with growth prospects in emerging and advanced economics far from certain. To protect the gains achieved to date, to further embed and sustain the recovery, and to ultimately spread the benefits of economic growth to all, we must continue to enhance all aspects of our competitiveness.

In this regard, costs are paramount: a competitive cost base helps to create a virtuous circle between inflation, wage expectations and cost competitiveness. On the other hand, high business costs make Ireland less attractive for foreign direct investment and reduce the competitiveness of Irish enterprises' goods and services trading in both the domestic and international markets.

As a small, open economy – dependent on both imports and exports - Ireland is particularly vulnerable to negative economic shocks which are outside the influence of domestic policymakers. In recent months, for instance, we have seen the challenges created for Irish firms exporting to the UK (and Irish firms competing against UK-based firms in other markets) resulting from the weakness of sterling on international currency markets. Such external developments reinforce the need to pursue policies to enhance Irish cost competitiveness.

Domestically, a number of short and medium term downside risks for Ireland have already emerged and these could potentially undermine national competitiveness, growth, and ultimately living standards. These pressures include emerging infrastructure bottlenecks, skills shortages and increasing levels of industrial unrest. Maintaining fiscal sustainability and a broad tax base, supporting structural reform, innovation, and productivity, and growing our enterprise and export base will remain significant immediate challenges.

Specifically in terms of costs, 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.

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 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 damage competitiveness. Likewise, the rapid increase in commercial rents – especially for retail property is a concern. Our previous property

boom was at the root of so many of our recent economic problems. We must try to avoid this sector undermining the current economic recovery and threatening its sustainability in the future.

The 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 cost pressures are emerging in a myriad of sectors.

The cost of credit for enterprise in Ireland is the third area the Council focuses on in the 2016 report. 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.

Finally, 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. Therefore, to ensure that wages are sustainable, wage growth should not outpace productivity growth but, at the same time, there must be a relentless focus on protecting real living standards by avoiding, as best as possible, significant increases in the costs of living. This is why the Council is advocating that attention be paid to a broad range of costs in an effort to promote a virtuous circle encompassing the costs of living, wage expectations, productivity and cost competitiveness.

Speaking at the launch of the report, Prof Peter Clinch, Chairman of the NCC commented: "Over the course of the recession, the Irish economy underwent a sharp correction in terms of our cost competitiveness. The recent appreciation of the euro vis-à-vis sterling provides a timely warning about just how vulnerable Irish firms are to external shocks: the appreciation of the euro has placed Irish exporters under increased cost competitiveness pressure. This reinforces the importance of prioritising policies and actions that are within Ireland's control to enhance cost competitiveness".

He continued: "There is a role for both the public and private sectors alike to manage proactively the controllable portion of their respective cost bases, drive efficiency and continue to take action to address unnecessarily high costs. Such actions will ensure that improvements in relative cost competitiveness are more sustainable, leaving Ireland better positioned to cope with external shocks. At the same time, productivity performance will assume an even more prominent role in driving Irish international competitiveness. Indeed, in the longer term, productivity growth is the preferred mechanism to improve competitiveness as it can support cost competitiveness in tandem with high and increasing income levels. There remains a need to increase the productivity levels across all sectors and occupations, particularly in Irish owned business".

The policy implications of this analysis, and associated structural reforms required to address Ireland's cost base will be included in the Council's annual Competitiveness Challenge report, which will be published in late-2016.

Key Findings

Labour

- Labour costs in Ireland have been growing marginally more quickly than in the euro area since 2014 and the wider EU-28 since the latter part of 2015
- While 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. We must ensure that wage growth is sustainable and thereby avoid finding ourselves in a position where wage growth outpaces productivity growth

- In 2016 Ireland had the 2nd highest monthly minimum wage (€1,546) and 5th highest monthly minimum wage in PPP terms (€1,264). As a percentage of average wages, Ireland has the 11th highest minimum wage.
- The levels of taxation in Ireland are below the euro area on average income levels and on marginal income levels for married couples. The corresponding marginal levels are, however, high for single earners
- Ireland is currently very reliant on taxes on income as a source of revenue, particularly when compared with other developed economies. On the other hand, significantly less revenue is generated through social security contributions in Ireland. Ireland has the 8th lowest rate of social security contributions in the OECD

Property

- The last number of years has witnessed a sustained recovery in the Irish commercial property market
- The cost of constructing a prime office unit and a High Tech Factory / Laboratory facility in Ireland both fell by almost 6 per cent between 2013 and 2015
- Commercial rents for both office and retail space grew strongly in 2015 - in 2015 prime retail rents increased by 22 per cent year-on-year
- Concerns persist about the availability of prime office space for rent in large urban centres in the short term as the market tightens and vacancy rates decline. This could result in future rent increases and any shortage of supply of new commercial space could adversely impact our competitiveness

Transport

- Irish petrol and diesel prices decreased by 2.5 and 8 per cent respectively in the 12 months to January 2016. However, the cost of 1,000 litres of diesel in Ireland (€1,199) was 9.2 per cent above the euro area average (€1,097) in January 2016
- Ireland was the 4th most expensive country with taxes on diesel accounting for the majority of this differential, representing 65.8 per cent of total diesel costs in Ireland – the 3rd highest proportion in the euro area
- With regard to service prices in the transport sector, prices have been relatively stationary in recent quarters. Air transport is a notable exception with rapid price growth recorded in recent years

Utilities

- The EU is among the most expensive locations for electricity and gas globally, and within the EU, Ireland is one of the most expensive countries for electricity for both large and small users - it is the 5th most expensive location in the euro area 17 for large electricity users
- Ireland is mid-table in the euro area in terms of industrial gas prices, but comparable prices in the US are substantially lower than in the EU
- On average, water and waste water costs for enterprise in Ireland compare favourably to those in competitor markets
- The cost of landfill has increased from €93 per tonne in 2010 to €113 in 2014 and Irish landfill costs are amongst the most expensive of the benchmarked countries/regions
- Thermal treatment costs (gate fees) in Ireland, although lower than landfill costs, are also among the most expensive in the benchmarked countries/regions.
- Ireland is relatively cost competitive for telecoms although concerns persist around the issues of quality (speed) and the regional availability of high speed services.

Credit and Financial Costs

- The cost of credit continues to act as a drag on the enterprise sector, inhibiting investment and growth, particularly amongst startups and SMEs
- In November 2015, the interest rate in Ireland on loans of up to €0.25 million was more than 80 per cent above the euro area average rate for new business; the rate on loans of up to €1 million was more than 60 per cent more expensive in Ireland
- Furthermore, Irish interest rates for commercial loans have been noticeably more volatile than euro area rates. Irish and euro area interest rates diverged further in 2014 and 2015
- Changes in the value of the euro impact significantly upon Irish competitiveness. Since 2013 the depreciation of the euro has aided Irish competitiveness. Exports to two of our main trading partners, the US and the UK, have increased accordingly. However, in recent months, sterling has weakened, increasing pressure on Irish based exporters

Business Services and Other Input Costs

- Overall since 2010, service prices have risen by more than manufacturing prices
- Services prices in Ireland have risen continuously since the beginning of 2012 and the magnitude of the increase has been higher than the EU-15 average during this period also
- While the price of legal services dipped for a brief period in 2013, in Q3 2015 legal service prices were 5.8 per cent higher than 2010 levels
- In international terms Ireland remains an expensive location in which to enforce a business contract
- Insurance prices have increased by 29.6 per cent since 2011; motor insurance prices have increased by 33.5 per cent over the same period and by 26.4 per cent in the last 12 months. These increases are well in excess of EU trends

Broader Cost Environment

- Ireland remains an expensive location in which to do business with a price profile which can be described as “high cost, rising slowly”
- Irish consumer prices remain over 20 per cent above the euro area-18 average
- The affordability of residential property is a key issue in overall competitiveness as both rental costs and purchase prices feed through into increased wage demands and rising living costs
- Residential rents are now back at pre-recessionary levels of 2007
- Childcare costs in Ireland are the second highest in the OECD for couples and the highest in the OECD for lone parents

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The full report is available at www.competitiveness.ie

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