GETTING IRELAND BREXIT READY

BUDGET 2017

October 2016

An Roinn Airgeadais
Department of Finance

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Foreword by the Minister >

The outcome of the UK referendum on EU membership presents important challenges for the Irish economy. While this arises at a time when Ireland's economic recovery is now firmly established across all sectors and the public finances are on a much firmer footing, we now need to protect the progress of recent years in the face of this new development.

This work has since been intensified and prioritised across all Government Departments and Agencies. As part of this response, it was agreed that Budget 2017 would include measures to support our overall economic response to Brexit.

Today's Budget sets out a range of tax measures to respond to the challenge of Brexit. They include the areas of SMEs, entrepreneurship, agri-food and Irish exporters. Important work is also ongoing by the Revenue Commissioners to scope out potential customs issues and identify approaches to minimise costs to business and to facilitate trade.

Work on the economic impacts of Brexit has been ongoing in my Department since well before the UK referendum including the funding of an ESRI study published in November 2015 under our joint research programme. Today we are publishing a more detailed analysis of sectoral exposure to Brexit across the economy which has been undertaken within the Department of Finance.

This document summarises the key findings of our sectoral analysis. The final impacts will, of course, depend on the future UK-EU relationship which will continue to be uncertain for some time. The measures set out in the Budget are an important first step in mitigating the impacts on the Irish economy from the economic implications of Brexit. The Government will remain proactive in developing and adapting our policies in order to ensure that Ireland's economy continues to remain competitive in the face of future economic headwinds. The Government will continue to work with Irish stakeholders, EU partners and with the UK with the aim of ensuring a strong future UK-EU relationship and a well-managed UK withdrawal.

Michael Noonan, TD
Minister for Finance

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1. Introduction

The aim of this paper is twofold. First it provides an overview of how Brexit may impact on the Irish economy. It identifies the sectors that are most exposed to the UK in terms of trade links and describes their key characteristics. The paper then provides an overview of the policy responses to Brexit that have been introduced in Budget 2017 to enable exposed sectors of Ireland's economy to remain competitive, and to protect the public finances from Brexit-related shocks.

1.1 Background and Context

Economic growth in Ireland has been firmly established across all sectors of the economy over recent years. The public finances are now in a much better position, and indeed the correction of the excessive deficit this year also represented a key milestone in the country's progress since the financial crisis period.

However uncertainties surrounding the international economic outlook have increased over recent months in line with emerging downside risks, including slowing global trade, continued modest growth in advanced economies, exchange rate movements and, in particular, the impact of June's EU 'leave' vote in the UK. The UK's decision is expected to have a material negative impact on the Irish economy.

Increased uncertainty and volatility in the financial markets following the referendum could undermine confidence while the depreciation of sterling will lead to a loss of competitiveness for Ireland. Indeed the economic forecasts underpinning the Budget, published today by the Department of Finance, and endorsed by the Irish Fiscal Advisory Council, have been lowered for next year, partly as a result of the UK vote.

As the UK brings to an end its forty-three years of EU membership, one of the challenges for policymakers and analysts will be to assess how economic trade and growth will be impacted over the medium-term. The severity of the impact however is difficult to gauge at this stage, as the terms upon which the UK will leave the EU are not clear. Crucially the severity of any impact on Ireland will also depend on what path the future relationship between the UK and the EU will take, especially regarding trade, financial flows, and the movement of labour.[1]

The Irish Government has sought to remain ahead of the curve in planning for the possibility of a UK exit. At an early stage, it funded a comprehensive scoping study by the ESRI of the possible economic implications of Brexit on Ireland.[2] This study was commissioned and

[1] See Barrett et al. (2015), "Scoping the Possible Economic Implications of Brexit on Ireland", ESRI Research Series Number 48, November 2015; IBEC (2016), "The impact of a possible Brexit on Irish business"; Davy Research (March 31, 2016), "The economic impact of Brexit on Ireland"; and Central Bank of Ireland (2015), "Macro-Financial Review (2015:II)".

[2] The ESRI scoping study was funded by the Department of Finance under the Taxation and Macroeconomy research programme. See Barrett et al., (2015).

completed in advance of any announcement from the UK Government on a referendum date and provided a head-start to policy-makers here in formulating economic plans and risk assessments.

In the immediate aftermath of the UK referendum, this Government set out in the Summer Economic Statement its first assessment of the short-term macroeconomic implications of Brexit. The Government also committed to a more detailed analysis in advance of the Budget. With this in mind, the Department of Finance has incorporated the impact of Brexit in its macroeconomic forecasts that underpin Budget 2017, and has also published an in-depth analysis of the most exposed sectors of the Irish economy to the UK.

Immediately following the UK referendum result, the Government put in place a Contingency Framework to map and manage the key issues, risks and opportunities that will be most important to Ireland in negotiations. Ireland's Brexit concerns have been outlined at the highest political level in Europe. The Government has also been working closely with the Northern Executive through the North South Ministerial Council to implement a set of ten specific actions which were agreed to optimise North South joint planning for Brexit including a full audit of key North-South work programmes.

The Government has put in place a number of arrangements to ensure a whole-of-Government response to Brexit, including a new Cabinet Committee which is overseeing the overall Government response to Brexit. In addition to this there will be a bigger role for the Minister and Department of Foreign Affairs and Trade on EU matters and a more focussed EU function in the Department of the Taoiseach as part of an integration of International, EU and Northern Ireland functions there, under a new Second Secretary General. Relevant Departments, agencies and overseas missions are also being strengthened to ensure that they are fit for purpose in dealing with Brexit issues.

Over recent months, in anticipation of Article 50 being triggered in early 2017, Departments have been examining all possible models for the future UK relationship with the EU, from continued membership of the single market to a full exit of the customs union.

Recognising the uncertainties ahead, the Government also committed that this year's Budget would be Brexit-proofed. Taking account of this commitment, and in light of the Department of Finance's in-depth sector analysis,[3] a number of taxation measures have been announced in the Budget, with a view to getting Ireland "Brexit ready". These are in the areas of: small and medium enterprises, Irish exporters, entrepreneurship, and the agri-food sector. Work is also underway at the Revenue Commissioners in the area of customs procedures in scoping the problems and identifying possible avenues to minimise the cost on business and maximise

[3] See 'UK EU Exit – An Exposure Analysis of Sectors of the Irish Economy', Department of Finance, October 2016

the facilitation of trade. On the fiscal side, cognisant of the risks that Brexit may bring, the Government is committed to the establishment of a “rainy day fund” and a new lower debt to GDP target to ensure the public finances can withstand any negative impacts from Brexit and other economic shocks.

2. Economic Implications of Brexit

A range of studies from within the UK,[4] and from international institutions,[5] show a loss in output in the UK over the short and medium term as a result of Brexit. The short run impacts are summarised in Table 1 below.

Table 1: UK impacts of a vote to leave the EU on the UK
Percentage difference from baseline level after two years

UK	UK Treasury		National Institute for Economic and Social Research (UK)		OECD	IMF[6]	European Commission[7]	
	Shock Scenario	Severe Shock	Optimistic Shock	Pessimistic Shock	Shock Scenario	Shock Scenario	Mild Shock Scenario	Severe Shock Scenario
GDP (%)	-3.6	-6.0	-2.3	-2.4	-1.2 to - 1.5	-0.2 to - 0.9	-0.3 to -0.9	-0.6 to -2.6

Given Ireland's close trade and financial linkages with the UK, the pass through of any losses from the UK to Ireland, or indeed from third country trading partners that are themselves impacted by Brexit, are likely to be material. It is important to note however that these impacts can be mitigated by carefully targeted measures. The responses announced in the Budget, and described in this paper, are a first step in this regard.

2.1 Sector Exposures

The Irish economy remains highly reliant on the UK as a trade partner with around 16 percent of all exports in recent years, and a similar share of imports, dependent on the UK. Ireland remains particularly reliant on the UK as a source of merchandise imports, with almost a 30 percent share sourced from the UK, much of which are intermediate goods used in the production process.

At the sectoral level, research published by the Department of Finance identified a number of mainly indigenous manufacturing sectors that are highly exposed to trade with the UK. These include:

- Food and Beverage;
- Electrical Equipment;
- Materials manufacturing; and,
- Traditional Manufacturing

[4] See for instance the UK Treasury analysis: the immediate economic impact of leaving the EU, May 2016, and the National Institute for Economic and Social Research; the Short-Term Economic Impact of Leaving the EU, National Institute Economic Review No. 236, May 2016.
[5] See Rafal Kierzenkowski, R., Pain, N., Rusticelli, E., and Zwart, S. April 2016. The Economic Consequences of Brexit: A Taxing Decision. Organisation for Economic Cooperation and Development Economic Policy Paper, No. 16. The International Monetary Fund's, July 2016, World Economic Outlook Update, and the European Commission's, July 2016, the Economic Outlook after the UK Referendum: A First Assessment for the Euro Area and the EU. Institutional paper 032.
[6] Note these IMF short-term scenarios are based only based on years 2016-2017.
[7] Note these EC short-term scenarios are based only based on years 2016-2017.

According to the CSO Census of Industrial Production (CIP) 2012, these sectors are highly dependent on the UK both as a destination for exports and for overall turnover. For instance, traditional manufacturers (i.e. textiles, clothing, leather, wood and paper products) rely on the UK for almost 36 percent of all exports and 13 percent of total sector turnover. A broadly similar picture is seen in the other exposed manufacturing sectors.

These sectors are also highly reliant on the UK as a source of intermediate goods for the production process. Of all materials used by traditional manufacturers, 22 percent come from the UK, and significantly almost half of all materials imported come from the UK, illustrating that the UK is the first port of call for imported materials. It should be noted that sectors that trade in bulky merchandise (i.e. high volume/low value products) tend to be most affected by the introduction of trade tariffs.[8]

Table 2	Exports			Imports	
Manufacturing Sector	**Share of turnover from exports**	**UK exports as share of total exports**	**UK exports as share of turnover**	**Share of intermediate goods sourced from UK**	**Share of imported intermediate goods that come from UK**
Food and Beverage	65%	15%	9%	12%	48%
Traditional Manufacturing	36%	36%	13%	22%	47%
Materials	38%	26%	10%	25%	46%
Electrical Equipment	49%	26%	13%	25%	30%

Source: Department of Finance (2016)

On average the exposed sectors are comprised of SME companies, with a high share of indigenous ownership. Indeed over 40 percent of turnover in food and beverage, traditional manufacturing and electrical equipment comes from indigenous companies and almost 70 percent in the materials manufacturing sector.

Whilst these sectors may be smaller in scale which lower profit levels relative to some of the large foreign-owned sectors (e.g. pharmaceuticals), they also tend to be more closely integrated with the rest of the economy as demonstrated by relatively high multipliers. For instance the multiplier of 1.5 in the food and beverage sector indicates that if the sector were to suffer a demand shock of €1 million, an additional €500,000 shock would hit the wider economy. Furthermore the majority of employment is outside of the Dublin area. Indeed out

[8] See Barrett et al. (2015), "Scoping the Possible Economic Implications of Brexit on Ireland"

of all regions in the country, the border region, the region with an unemployment rate of over nine percent, records very high shares of employment in the most exposed manufacturing sectors relative to other regions.

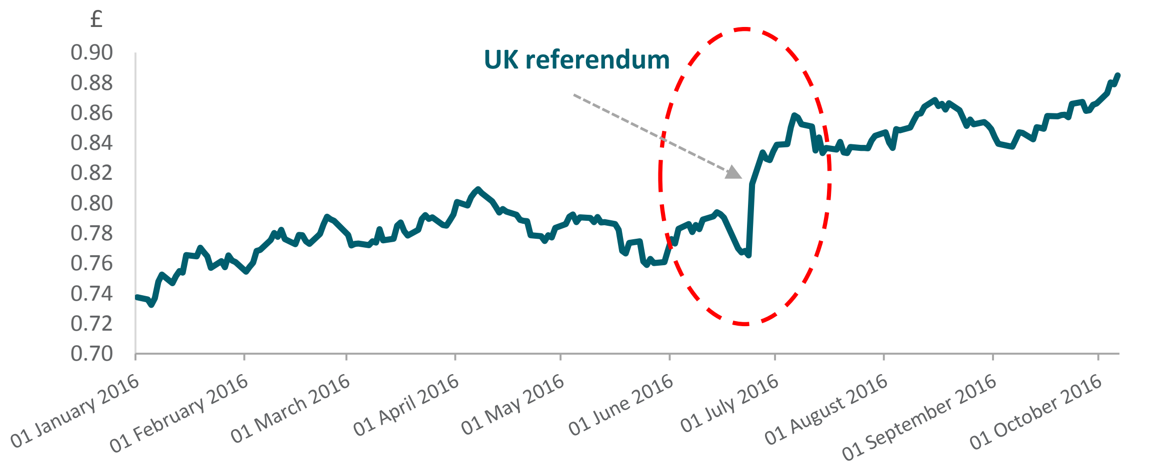
Table 3	Irish Owned Companies	Employment	Linkages with Economy
Manufacturing Sector	Irish Turnover as share of Total Turnover by Sector	Employment outside Dublin as % of Sector Total	Output multiplier
Food and Beverage	46%	78%	1.5
Traditional Manufacturing	44%	69%	1.4
Materials	69%	86%	1.4
Electrical Equipment	42%	91%	1.2

Source: Department of Finance (2016)

Whilst services sectors would not be affected by trade tariffs to the same extent as some of the most exposed manufacturing sectors, certain services sectors such as the indigenous tourism and hospitality sector will be equally exposed to the competitiveness challenges posed by the recent sharp depreciation of sterling vis-a-vis euro.

The depreciation of sterling since the referendum, as illustrated in Figure 2 below, makes Ireland relatively more expensive for British visitors to travel, stay and purchase goods and services in Ireland. Ireland's tourism sector, which accounts for over 150,000 jobs in Ireland, is highly dependent on the UK market with 3.5 million overseas trips to Ireland and spending in the region of nearly €1 billion here last year made by those coming from the UK in 2015.

Figure 1. Euro versus UK sterling currency rate movements (2016)



Source: Bloomberg data. Department of Finance analysis.

Overall therefore, the sectors most exposed to the UK are generally comprised of indigenous enterprises that are small in scale, are highly linked to the rest of the economy, have high levels of regional employment, and have relatively low profit levels. For these domestically exposed sectors, the following measures are being introduced in Budget 2017 to enable these sectors to remain competitive and to trade in diversified markets.

Sectoral Tax Policy Responses

- Reduced Capital Gains Tax to help entrepreneurs
- An extension and amendment of the Foreign Earnings Deduction to help Irish exporters to diversify their export and import markets
- An extension of the Special Assignee Relief Programme to assist businesses to relocate key staff to Ireland
- An increase to the Earned Income Tax Credit for self-employed tax payers to encourage entrepreneurship
- The introduction of an income averaging “step-out” in the agriculture sector to help with expected volatility in demand for agri-food products following severe price fluctuations
- The retention of the 9 percent VAT rate to help the tourism and hospitality sector to maintain competitiveness in light of recent currency movements

The outcome of the referendum on the UK’s membership of the EU has led to significant currency volatility. In order to provide support to farmers, a €150 million loan fund will be developed to improve cash flow management and reduce the cost of short term borrowings.

The Department’s research also showed that Ireland’s exposure to the UK is not only linked to the indigenous sectors. Pharmaceutical manufacturing and financial and ICT services, sectors with high foreign ownership, have a substantial export relationship with the UK. The Government’s ongoing commitment to the 12.5 percent corporation tax rate, as well as the R&D Tax Credit and Knowledge Development Box, and the announcement of an extension of the Special Assignee Relief Programme are key policy measures that will help Ireland to remain competitive to these and other foreign sectors and to continue to attract jobs.

Indigenous and foreign exporters that trade with the UK depend on the efficient movement of their products. With this in mind, the Revenue Commissioners are currently engaged in scoping the problems and identifying possible avenues to minimise the cost on business and maximise the facilitation of trade in a post Brexit world.

Recognising the uncertainties ahead, the Government has committed to the establishment of a “rainy day fund” and a new medium term debt to GDP ratio of 45 percent (to be reached by the late 2020s) to ensure the public finances are in a position to withstand any Brexit-related shocks.

3. Responses to Brexit

In light of the findings in the Department of Finance's sectoral analysis, and with a view to protecting the public finances from Brexit related shocks, the following measures have been introduced in Budget 2017.

3.1 Reduced Capital Gains Tax to help Entrepreneurs

Last year, Budget 2016 included the announcement of a revised Capital Gains Tax (CGT) entrepreneur relief. From 1 January 2016 qualifying business disposals made by qualifying individuals have been charged a reduced rate of CGT up to a lifetime limit in chargeable gains.

A qualifying individual is someone who holds 5 percent or more of the shares in the company (or is a sole trader or owns the company outright) and has worked as a director or employee of the company for 3 out of the previous 5 years. Qualifying assets are shares in or assets of any company other than those involved in certain excluded activities, including dealing in shares, securities, commodities, land or property.

The purpose of the relief is to make setting up a business a more attractive option for potential entrepreneurs, and especially to encourage those who are considering starting or growing a business to do so in Ireland rather than elsewhere.

The relief currently applies a 20 percent rate of CGT, rather than the general rate of 33 percent, up to a lifetime limit of €1 million in chargeable gains.

Budget 2017 provides that from 1 January 2017 the applicable rate will be reduced to 10 percent. This will make the relief significantly more attractive, and should increase its effectiveness in achieving its aims.

This change will bring the relief more in line with the equivalent relief in place in the UK, which offers a 10 percent rate. The relief here was introduced and is now being amended to tackle the issue of people who might have founded or grown a business here choosing to do so elsewhere, particularly the UK. In the context of the UK departure from the EU this issue gains importance. The pattern which has already begun of the UK strengthening its tax offering to business as a balance to the uncertainty arising from the process of their departure from the EU is likely to continue, and a response here is appropriate. Questions of whether to situate a business here or in the UK will be further affected by relative changes in the value of the euro vs sterling and by the nature of the trade agreements between our countries, particularly given the significance of the UK market for Irish businesses.

3.2 Foreign Earnings Deduction

Budget 2017 is extending the Foreign Earnings Deduction (FED) until the end of 2020 and is adding Colombia and Pakistan to the list of qualifying countries. In addition, the minimum number of days for travel is being reduced to 30 to help SMEs with access to the incentive.

FED was introduced in order to assist with the diversification of trade into non-traditional export markets for Irish goods and services. The incentive provides for a deduction from salary of up to a maximum of €35,000 for employees who travel to qualifying countries as part of the duties of their employment. Diversification is especially important in the current climate where we are unsure of the trading conditions Irish companies will face for trade with the UK post Brexit. The changes will expand the level of support to all businesses, including small and medium sized enterprises, who are looking to expand and grow their export markets.

3.3 Special Assignee Relief Programme

Budget 2017 is extending the Special Assignee Relief Programme (SARP) until the end of 2020. The extension is to provide certainty for foreign direct investment in Ireland, following on from the UK vote to leave the EU.

Introduced in Budget 2012, SARP is aimed at reducing the equalisation cost to companies of assigning skilled individuals and key decision makers from abroad to take up positions in the Irish based operations of the employer, relevant employer or an associated company. For example, such individuals could be transferred to head up new divisions of the company or take charge of new product development and thus the relief has the potential to lead to additional investments in Ireland. The measure acts to secure and embed investment, which can lead to sustainable growth and strengthens Ireland's innovative capabilities.

3.4 Earned Income Tax Credit

In order to support indigenous entrepreneurs and small businesses, Budget 2017 provides for an increase to the Earned Income Credit of €400, bringing the credit up to €950 with effect from January 2017. The Earned Income Credit was introduced in Budget 2016 and is available to self-employed individuals who do not have access to the PAYE credit. It supports sole traders, including farmers, who are generating economic activity across the country and, in many cases, competing in an increasingly globalised marketplace.

3.5 Income Averaging Step Out

Budget 2017 is introducing a step out for farmers who have opted for income averaging, which may go some way towards helping farmers combat the additional volatility Brexit may bring. It allows farmers a reduced tax liability in a year when their income is low to allow for a period of recovery.

Income averaging is an alternative method of arriving at the taxable profit figure for farmers using an average of 5 years. The system works by averaging the last 5 years income on a rolling basis. The objective is to help to counteract the high volatility in income that is associated with the sector. The benefit of income averaging is gained where there is a year of low income; unused tax credits and bands are effectively transferred to the other years. Bearing in mind that income averaging is somewhat counter-cyclical; in years when profit is low, a farmer would have a higher tax liability compared to the liability for that year alone.

The step out is being introduced so that when farmers in the income averaging scheme encounter an unexpectedly poor year for income, that they would be permitted to "step-out" from income averaging in that year. For this year, farmers would pay the liability for that year alone, and in subsequent years, would return to income averaging. This would effectively mean that a farmer could defer the tax due on the averaged profit this year to future years. A farmer is only permitted to step out once in a 5 year period, with the condition that they remain in the income averaging system in the subsequent year.

The income averaging step out will have cash flow benefits to a farmer in a year in which income is low. This will be especially beneficial to dairy farmers this year who have seen extremely low prices.

3.6 Retention of the 9 Percent VAT Rate

The Programme for a Partnership Government, published in May 2016, commits to working towards achieving the ambitious tourism policy goals set for 2025 of growing employment in the tourism and hospitality sector and increasing the number of visits to Ireland through specific measures such as “the retention of the hugely successful 9 percent VAT rate on tourism and hospitality related services, providing that prices remain competitive.”

The 9 percent reduced VAT rate for tourism and hospitality related services was introduced in July 2011 as part of the previous Government’s Jobs Initiative. The measure was designed to boost tourism and create additional jobs in that sector. The tourism and hospitality sector is a key sector in the Irish Economy and the introduction of the 9 percent VAT rate was aimed at reducing costs during a very challenging time for the sector.

Ireland’s tourism and hospitality sector is heavily dependent on UK tourists with just over 3.5 million UK tourists visiting Ireland in 2015 and spending nearly €1 billion here last year, according to the CSO. However, sterling has weakened significantly against the euro following the Brexit referendum and as a result, Ireland has become a more expensive location for UK tourists; one of our key markets. In order to remain competitive and continue to attract UK and overseas tourists the 9 percent VAT rate is being retained in Budget 2017.

3.7 Customs Procedures

Until the UK ceases to be a member of the EU, all trade and business dealings between Ireland and the UK continue unchanged. After that, customs procedures may apply to the movement of goods and services between Ireland and the UK The possibility of tariffs or restrictions on trade are separate issues which must be negotiated.

Customs procedures would be needed not only to monitor trade but also to ensure the correct operation of excise law, VAT and regulations such as those on the health of animals and the quality of foodstuffs. The final shape of the agreement between UK and EU will determine whether there are customs duties to be paid, whether there are restrictions on certain goods and services, and whether the customs procedures are relatively simple or more complex and onerous.

The Revenue Commissioners are currently engaged in scoping the problems and identifying possible avenues to minimise the cost on business and maximise the facilitation of trade. Revenue is part of the Inter Departmental Group under the chairmanship of the Department of the Taoiseach which meets regularly to ensure that all contingencies and concerns are fully considered. Separately, Revenue chairs the Customs Consultative Committee which comprises business and trade representatives, where problems and concerns are discussed and resolved.

For the moment, only preliminary scoping is possible. After formal negotiations begin, detailed planning can commence on providing the necessary trade facilitation supports at ports, airports and the land frontier, as well as the IT and other resources to ensure a smooth flow of trade. As that planning proceeds, information and support for business will be a central part of Government strategy, so that, on whatever date the UK exit actually occurs, there will be no surprises and minimal disruption.

While the majority of expenditure by Revenue on Brexit readiness will take place in later years, specific additional funding has been included in the 2017 Revenue Estimate.

3.8 Review of Stamp Duty on Share Transactions

The transfer of stocks or marketable securities of an Irish incorporated company is liable to Irish stamp duty at a rate of 1 percent.

It is proposed to carry out a review in 2017 of the application of stamp duty to stocks or marketable securities of an Irish incorporated company in the context of the sustainability of the stamp duty yield and the future UK relationship with the EU. The Review will also take account of competitiveness issues.

3.9 SBCI Agriculture Loan Fund

The outcome of the referendum on the UK's membership of the EU has led to significant currency volatility. In order to provide support to farmers, the Minister for Agriculture, Food and Rural Development will be utilising EU exceptional adjustment aid to develop, in conjunction with the Strategic Banking Corporation of Ireland, a €150 million loan fund that will be low cost and highly flexible. The loans will enable farmers to improve the management of their cash flow and reduce the cost of their short term borrowings, which are particularly important when facing currency and price volatility. This loan fund is an innovative use of EU aid that maximises the support available for farmers, as opposed to using the funds for more limited purposes.

3.10 Rainy Day Fund

As with all economic risks, any fallout from Brexit may impact on the public finances. It is critical therefore that we take appropriate action to prepare for these possibilities. Building up buffers in the public finances will improve our capacity to weather future shocks.

The "rainy day fund" that was announced in the Summer Economic Statement will commence in 2019 after Ireland has achieved its Medium Term Objective under the EU's fiscal rules and is running balanced or surplus budgets. It will provide an initial shock absorption capacity if needed following Brexit, or other economic shocks.

3.11 New Medium Term Debt to GDP target

The most important mitigation measure available to the exchequer in the event of a shock is the ability to borrow. While Ireland's debt to GDP ratio has improved to 76 percent this year from 120 percent in 2013, the national debt is still too high. At today's debt ratio our ability to borrow to withstand a major shock is not as strong as it could be. Indeed it stands at a much higher level than it did in 2008 going into the financial crisis period. While the Stability and Growth Pact requires us to reduce our debt to GDP ratio until it reaches reach 60 percent of GDP, this is unlikely to be sufficient for a small open economy subject to heightened risks. Accordingly the Government has decided to set a new domestic target of a debt to GDP ratio of 45 percent to be reached by the mid-2020s, or thereafter, depending on economic growth.

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