Employment and Investment Incentive

Ex-Ante Economic Impact Analysis

Department of Finance
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1. Background

1.1 The Business Expansion Scheme (BES) was introduced in 1984 to incentivise private investment in long-term equity capital in companies.

1.2 The scheme assists in the creation and retention of jobs in certain small and medium-sized enterprises (SME) located in Ireland, through the provision of capital investment, which companies would otherwise find difficult to raise.

1.3 The scheme was reviewed in 2006 and subsequently extended until 2013. The reasons for this extension included;

- the clear market failure in providing equity capital for small firms in their start-up and early development phases,
- the evidence of how vital the scheme has been in the past for such firms and continuing needs in this regard, and
- the potential return to the economy from indigenous Irish companies.

1.4 Under the current BES, individuals that purchase ordinary share capital of qualifying companies can get tax relief at the marginal rate on the value of their investment provided that they hold the shares for a minimum of five years. The maximum investment (per investor) that can be tax relieved is €150,000 per annum. However, as the scheme is one of the specified reliefs for the purposes of the high earner's restriction, the changes introduced in Budget 2010 to that restriction, means that this maximum investment threshold could not be fully tax relieved in a single tax year. The maximum lifetime limit that a company can raise under the scheme is €2 million.

2. Impact of the Economic Downturn

2.1 SMEs are the wellspring of employment and innovation in this economy. Given that job creation and protection is a top priority of the Government, it is essential that the BES is targeted and evaluated against jobs created or retained. With the advent of the economic downturn, it was decided to bring forward the planned review of the BES, in order to examine if the scheme could be amended to provide further assistance to companies that were having difficulty raising capital investments and to assist them to generate and retain employment.

2.2 SMEs are a significant feature in the Irish economy, accounting for an estimated 53% of total employment (Q3 2010). Indigenous firms are also more likely to be found in the SME category, implying they are an important source of retained earnings domestically. [1]

2.3 In 2009, a total of €62.3 million was invested in companies through BES, at a cost of €25.6 million to the Exchequer. This was down from €135.7 million in 2008, which cost the Exchequer €55.7 million, a decrease of 46%. Early indicators would suggest that the level of capital raised under the scheme will further reduce in 2010.

[1] Central Bank of Ireland, 2010 Lending to Small and Medium Sized Enterprises: Q1 – Q3 2010

The reasons behind the reduced investments in the BES could be related to the following;

- less investment capital available due to the economic downturn,
- investors becoming more risk averse as a result of the economic downturn,
- the effect of the restriction of reliefs measure.

Indeed a combination of all these factors could be at play.

The cost of the BES over recent years is set out at paragraph 2.5.

2.4 In the temporary community framework for state aid measures to support access to finance in the current financial and economic crisis[2], the European Commission recognised that '*The turmoil on the financial market has had a negative effect on the risk capital market for early growth SMEs by tightening the availability of risk capital. Due to the currently greatly increased risk perception associated with risk capital linked with uncertainties resulting from possibly lower yield expectations, investors are currently tending to invest in safer assets the risks of which are easier to assess as compared to those associated with risk capital investments. Furthermore the illiquid nature of risk capital investments has proven to be a further disincentive for investors. There is evidence that the resulting restricted liquidity under current market circumstances has widened the equity gap for SMEs. It is therefore considered appropriate to temporarily raise the safe-harbour threshold for risk capital investments to meet the increased equity gap…*' This threshold was increased to €2.5 million per annum for the duration of the temporary framework and has now been adopted within the Community Guidelines on State Aid to promote risk capital investments in small and medium-sized enterprises[3], which operate until the end of 2013.

2.5 The table below shows the cost of the BES, in terms of tax foregone, for the period 2006 – 2009.

Year	**Cost**
2006	€21.4 m
2007	€17.5 m
2008	€55.7 m
2009	€25.6 m

2.6 When the BES was amended and extended for a further 7 years in Budget 2006, it was estimated at that time that the changes would cost an additional €25.4 million in a full year. As can be seen from the table above, the increased investments sought by the changes were only actually experienced in the 2008 tax year, given the normal time-lag for such tax based changes.

2.7 In 2007, the scheme was not operational until August, as the approval of the European Commission for the extended scheme was awaited. However, the cost of the

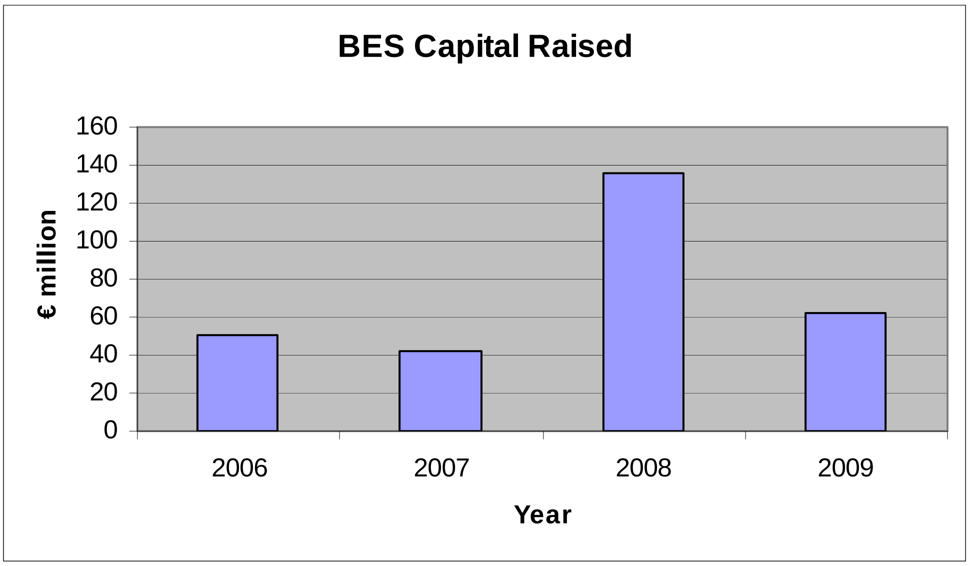
[2] 2009/C 16/01
[3] 2006/C 194/02

scheme has gradually returned to 2006 levels approximately, despite having been enhanced for the 2007 and subsequent tax years.

2.8 Compare this with the cost of film relief (shown in the table below) which has remained relatively constant and indeed increased by almost a third in the most recent year for which statistics are available. Both schemes have broadly similar objectives and although this comparison does not take into account the cost effectiveness of both, the difference in take-up highlights the case for a change in the design features of the current BES.

Year	**Cost**
2006	€36 m
2007	€31 m
2008	€33 m
2009	€42 m[4]

2.9 The graph below shows the level of capital raised by companies under the BES over the last four years.



3. Employment Intensity

3.1 Since its inception, the BES has proved successful in helping small and medium-sized companies gain access to capital investments, with a view to supporting job retention and creation in the State.

3.2 Small and medium size companies are important sources of employment. According to CSO *Business Demography* data, enterprises with less than 10 employees employed 20% of the total 1.3 million employees in active enterprises in Ireland in 2008.

[4] Provisional Figure

3.3 Small companies continue to generate new jobs despite the economic downturn. The annual number of newly created companies fell by 8% between 2006 and 2008, but the numbers employed by new companies actually increased by 23% over the same period. This is because the employment intensity in small businesses increased over the period.

3.4 Approximately 1,770 companies have participated in the BES since 2001. Data show that these companies as a group employed 19,700, 20,700 and 20,100 in 2006, 2007 and 2008 respectively. The PAYE income tax paid by these employees is significant, for example for 2008 the PAYE revenue from this group was over €70 million.

3.5 For companies that participated in the BES in recent years, rather than the period from 2001 overall, the data suggest that BES companies continue to generate employment. Of the 1,770 BES companies that have participated in the BES since 2001, 189 registered for corporation tax after 2006 and this group employed nearly 1,200 people in 2008.

3.6 Job creation is a top priority of Government at the current time. Tax reliefs and incentives are being reviewed and scrutinised with a view to severe curtailment and even abolition. Against this background, it is important that schemes like the BES are targeted and evaluated against the numbers of jobs created or retained. In this regard, it would be important to ensure that tax relief available under any amended BES will be focused on job retention and creation.

4. Qualifying Trades

4.1 Access to the BES is currently restricted to investments in a list of qualifying trades which are set out below:

- The manufacture of goods (including computer services),
- The operation of certain tourist traffic undertakings,
- Internationally traded services,
- The cultivation of mushrooms,
- The micro-propagation of plants and plant cloning,
- The cultivation of horticultural produce in greenhouses,
- Research and development activity which is undertaken with a view to carrying on certain of these qualifying trading operations,
- Commercial research and development activities,
- The construction and leasing of advance factory buildings,
- The production, publication, marketing and promotion of certain musical recordings by a new artist, and
- Recycling activities in relation to waste material, which has been subjected to any process or treatment, which results in value-added material that is reusable. Waste material means any of the following: packaging; construction and demolition waste; metals, wood, glass and plastics; electrical and electronic equipment; batteries; end of life mechanically propelled vehicles.

4.2 In order to qualify for the BES, it is necessary for certain companies to be certified by various State bodies or Agencies that have expertise or oversight responsibilities for the sectors set out in paragraph 4.1. Those companies that have gone through this certification process have often complained that it is overly complex and places an administrative burden on the company.

4.3 Due to the economic downturn, and the significant increase in unemployment across the country, it seems counter productive to retain the restrictions on the type of companies that can raise capital under the scheme. Given that the intention of the scheme is to generate and retain employment, it seems logical that it should be available to small and certain medium-sized trading companies regardless of the trade that they undertake.

4.4 As noted by the OECD, small and medium sized companies are strategic drivers of innovation in an economy.[5] Even though innovation is typically dominated by larger companies, small companies have an important role to play in introducing and commercialising innovation. By broadening the qualifying trades, it would allow companies in a wider range of sectors access to the scheme. In particular, it would support companies engaged in smart economy type activities, which will expand in significance as the Irish economy recovers and returns to growth.

4.5 A wealth of opportunities exist in such smart economy sectors such as services, tourism, food, education, life sciences, software, creative industries, next generation network-enabled sectors, clean technology and green enterprise, construction and the built environment and 'silver' technologies that improve the well-being of older people.[6] It is important that companies in these areas are able to access this incentive to promote growth in this rapidly expanding and potentially lucrative sector.

5. Company Investment Limit

5.1 The company lifetime investment limit under the scheme is set at €2 million. Preliminary statistics would indicate that almost 40 companies have reached, or will soon reach, this limit. Such companies could have the potential to grow employment further, if they could raise more capital under the scheme. However, this is not possible due to the current limit. At the same time, access to capital raising opportunities from the market for these companies might be curtailed, as a result of the economic downturn. Against this background, a review of the company lifetime limit under the scheme seems appropriate.

5.2 The company lifetime limit in its current form severely curtails certain businesses from expanding, necessitating the sale of the business concerned in order that adequate funding can be provided to facilitate the next stage of business development. Some Irish companies may have been lost to Ireland as they have been sold to larger foreign companies due to an inability of the company to raise capital to fund further expansion. An increase in the company lifetime limit could increase the capacity of such companies to expand in Ireland and thus create additional

[5] OECD, 2009, *Taxation of SMEs – Key Issues and Policy Considerations*, OECD Tax Policy Studies.
[6] Department of Enterprise, Trade and Innovation, 2010 – Trading and Investing in a Smart Economy.

employment here. This is an important factor if Ireland is to develop a critical mass of innovative, indigenous SMEs, which are critical to maintaining economic growth and ensuring that Ireland can benefit from a future improvement in the world economy.

6. Private Investor Limit

6.1 Investors can currently claim tax relief on investments under the BES of up to €150,000 per annum. Preliminary information from the Revenue Commissioners shows that the number of investors making the maximum investment under the scheme dropped in 2009 to 28, less than a third of those that made the same investment in 2008 (87). The reduced amount invested by such individuals could be related to a lack of appetite for risk capital investments, as a result of the economic downturn. It could also be related to the restriction of reliefs measure, which only allowed high earners to fully claim tax relief on specified tax incentives of up to €250,000 per annum. If the latter measure is a significant factor in the reduced investment levels, then the further restriction that was introduced in Budget 2010, which only allows high earners to fully claim tax relief on specified tax incentives of up to €80,000, will further reduce investments in the BES.

6.2 The removal of the BES from the restriction of reliefs could greatly encourage investors to increase their investment levels and it is an issue which could be usefully explored for future action. In addition, increasing the investor limit that can be invested per annum would also assist companies by reducing the number of investors that would need to be sourced to allow for the necessary funding level to be achieved.

7. Proposed Reform of BES

7.1 The Government has decided, subject to European Commission approval, to reform the BES Scheme into a new incentive called Employment and Investment Incentive (EII).

- The new scheme will remove the qualifying trades' limitations and open up the scheme to the majority of small-sized trading companies and medium-sized trading companies[7]. It is intended that the removal of the qualifying trade limits will encourage investors to invest in a broad range of companies, and to enable these companies to generate and maintain employment. It could also be argued that the extension of eligibility for new sectors could allow the EII to achieve benefits in areas where unemployment has been disproportionately felt. Expanding the scope should allow the new incentive to minimise displacement, by reducing the incentive for beneficiaries to focus commercial activity on a narrow range of business sectors in order to benefit from the scheme. There is a risk that certain companies could raise investments without having access to the scheme, and thus there is scope for deadweight in the extension of the scheme to the majority of trading companies. However, investors at the current time are risk averse and the potential for deadweight is limited.

[7] provided they are not in expansion stage and located in non-assisted areas, in line with the Community Guidelines.

- The certification requirements for the majority of qualifying companies will be changed such that they will be subject to a simple and efficient certification process. Currently, many companies have to be certified by the relevant State agency in order to qualify for the scheme. This can be a long and complex process. It is envisaged that the Revenue Commissioners will allow most companies to qualify for the scheme where they meet the requirements for company size and where they are not on the list of excluded trades.

- The maximum amount that can be raised by companies in a 12 month period will be increased from €1.5 million to €2.5 million, in line with changes to the Community Guidelines on State Aid to promote risk capital investments in small and medium-sized enterprises.

- The lifetime amount that can be raised per company will be increased from €2 million to €10 million. This increase, along with enabling companies to expand, will also aid companies operating in the renewable energy sector obtain access to a greater level of funding in order to reach production stage.

- The tax relief available for investments will be reduced from 41% to 30% with a consequent reduction in the required holding period for share capital from 5 years to 3 years.

- A further 11% relief on the initial investment will be available where it has been proven that employment levels have increased at the qualifying company at the end of the holding period, or where evidence is provided that the company incurred expenditure on Research and Development. This portion of the relief, where due, will not be subject to the high earners restriction.

8. Objectives of EII

- To support the creation and retention of employment in small and medium sized enterprises across the economy. Part of this value-added aim includes a positive impact on Exchequer cashflows such as increased provision of payroll taxes, corporation tax, as well as savings on social protection payments.

- To help address the market failure in relation to equity capital investment, which can act as a barrier to sales growth and market development for SMEs.

- To help the survival of companies (and their retention in Ireland) beyond the initial development stage.

9. Potential Cost of EII

9.1 The following tables show the amounts raised and the Exchequer costs of the BES per sector in 2008 and 2009.

Year	Sector	Amount Invested €m	Exchequer Cost €m
2008	Manufacturing	76.2	31.3
	International Services	54.5	22.4
	Tourism	4.3	1.8
	Other	<1	<1
	Total	135.7	55.7

Year	Sector	Amount Invested €m	Exchequer Cost €m
2009	Manufacturing	27.8	11.4
	International Services	30.5	12.5
	Tourism	1.5	<1
	Other	2.5	1
	Total	62.3	25.6

9.2 Although it is difficult to forecast the likely take-up and the spread between sectors of qualifying investments for the new incentive, a number of scenarios are put forward below using simple extrapolation of increases in investments (based on figures from 2009). For the purposes of analysis, it is assumed that the distribution of take-up by sector will remain constant.

9.3 <u>Neutral Scenario</u>

A 20% increase in take-up would result in the following amounts being raised and the associated costs to the Exchequer.

	Amount Invested €m	Exchequer Cost €m
Manufacturing	33.4	10
International Services	36.6	11
Tourism	1.8	<1
Other	3	<1
Total	74.8	22.4

In this scenario the actual cost of the incentive to the Exchequer would be lower, due to the change in the up front relief level from 41% to 30%.

9.4 <u>Pessimistic Scenario</u>

A 10% increase in take-up would result in the following amounts being raised and the associated costs to the Exchequer.

	Amount Invested €m	Exchequer Cost €m
Manufacturing	30.6	9.2
International Services	33.6	10.1
Tourism	1.7	<1
Other	2.8	<1
Total	68.7	20.6

Under this scenario the actual cost of the incentive to the Exchequer would again be lower, due to the change in the up front relief level from 41% to 30%.

9.5 Positive Scenario

A 100% increase in take-up, which would take investments close to 2008 levels, would result in the following amounts being raised and the associated costs to the Exchequer.

	Amount Invested €m	**Exchequer Cost €m**
Manufacturing	55.6	16.7
International Services	61	18.3
Tourism	3	<1
Other	5	1.5
Total	124.6	37.4

9.6 The removal of the qualifying trades restriction has the potential to increase the costs to the Exchequer of the scheme. If the number of qualifying companies doubled, for example, and the current investment pattern remained constant, then the annual cost of the scheme would increase to approximately €37 million. However, this would equate to companies raising up to €125 million in risk capital.

9.7 The increase in the company lifetime limit to €10 million is likely to increase the cost of the scheme to a limited extent. If all 40 companies that have already raised approximately €2 million, were to raise a further €7.5 million each over the period 2011- 2013 then the additional cost would be in the region of €90 million over that 3 year period. However, it is unlikely that all of these companies could raise the maximum amounts under the scheme.

9.8 The scenarios set out above take account of the reduced amount of tax relief proposed for investments in the initial stage of the incentive. It would be hoped that the level of capital raised under the scheme would increase such that no actual reduction in the cost of the scheme would be experienced. The additional 11% relief available where jobs have been created will increase the costs of the scheme somewhat but these increased costs will not be encountered until 2014 at the earliest.

9.9 Notwithstanding the reduced amount of relief available and the safeguards relating to job creation, there is a risk, as with all tax incentives, of deadweight arising with the incentive. Beneficiaries may make investments which they would have made in any event in the absence of the incentive. However, it is expected that deadweight will not be significant given the lack of capital for SMEs.

10. Potential Benefits of EII

- The existing BES has assisted in the creation or retention of considerable numbers of jobs – for example, in 2008 there were over 20,000 people employed in companies that used the BES since 2001.

- Despite the downturn in the economy, the companies using the BES in recent years continue to be employment intensive. BES companies registered since 2006 had an average of 6.3 employees per company in 2008.

- The 189 BES companies that registered for corporation tax since the beginning of 2006 had 1,200 employees in 2008. If the EII is successful and, for example, doubles the number of new companies to 378 over the next two year period, then based on an employment intensity of 6.3, those companies could support the creation of approximately 2,400 jobs by the end of 2012. This would be in addition to supporting the retention of other jobs.

- The employment intensity of 6.3 on average for the recent BES companies is quite high compared to that of new companies generally – from CSO data on enterprise births, more than half of new companies have only one person employed (often the individual that establishes the company).

- The EII will be more tightly focussed on employment creation and retention and if successful would likely increase the 6.3 employment intensity further. The enhancements under the EII would encourage further investors and companies and this would be expected to generate similar gains in job creation and retention but in greater numbers.

- The removal of the qualifying trades' restriction will allow additional companies to access the BES and could lead to increased job creation and retention.

- The provision of additional jobs and indeed the retention of existing ones will lead to Exchequer gains as income tax revenue increases and additional savings on social protection payments are achieved. The average amount of income tax paid per employee working in a BES supported company in 2008 was €3,511. Using this figure and the estimation of approximately 2,400 new jobs over a two-year period, the possible Income Tax yield to the Exchequer from these additional jobs would be approximately €8.4 million by the end of 2012. The maximum adult rate of Jobseekers Allowance is €188 per week or €9,776 per annum for a single person. If we use this figure along with the estimated job creation, the potential saving to the Exchequer on Social Protection payments is approximately €23.5 million by the end of 2012.[8]

- Job retention and creation will ensure support for supplier and service industries leading to further job retention and possible creation.

- The reduced administrative overhead for companies and for State bodies will lead to cost savings for the State and for businesses. Small companies have limited resources and so administrative costs are particularly onerous and difficult for them. As noted by the European Commission Expert Working Group on taxation and small companies, reporting requirements should be as

[8] These figures are subject to deadweight and displacement caveats.

simple as possible to encourage growth and tax compliance among small and medium sized enterprises.[9]

- Access to capital through the scheme will facilitate long term investment for companies. This will reduce dependence on loans and thereby reduce costs for businesses.

- Increasing the company limit will support the retention of larger scale projects and businesses in Ireland.

Statistics on the uptake and the cost of the BES are generally available more quickly than those for other tax expenditures. As a result of this, should the costs of the scheme increase beyond that which is expected, it will be possible to amend the scheme relatively quickly such that the exposure of the Exchequer is reduced.

[9] European Commission, 2007, Simplified Tax Compliance Procedures for SMEs, Final Report of the Expert Group, http://ec.europa.eu/enterprise/newsroom/cf/_getdocument.cfm?doc_id=3431.