The SME Sector in Ireland – Information paper

Tax Strategy Group Paper September 26th 2006

INTRODUCTION

The paper provides information on the size and structure of Small and Medium-sized Enterprises (SMEs)[1] in Ireland; outlines the issues facing this sector and considers policy issues in relation to supporting the sector's development.

I. IMPORTANCE of SME (SMALL AND MEDIUM-SIZED ENTERPRISES) SECTOR

Ireland has a population of around four and a quarter million people; approximately two million are in employment, and of these, 350,000 work for Government departments, State agencies or other public sector bodies (including health and education), and over 100,000 work in agriculture.

The rest work in the enterprise sector – manufacturing industry, services, construction, wholesale and retail, hotels and restaurants, transport, self-employed professionals, and so on. Around half of these – 777,000 people – work in businesses that employ fewer than 50 people.[2] Given the size of the sector, it is clear that the success of the SME sector is a vital determinant of wellbeing of the whole economy.

Given the importance of the SME sector, policymakers need to have appropriate information on the size, features and challenges facing the sector. The Irish economy is in a period of transition, as domestic demand rather than the external side of the economy becomes the main source of economic growth. As the current rate of growth in construction is unlikely to continue, it is important that other sectors, such as SMEs, become an increasing source of economic growth.

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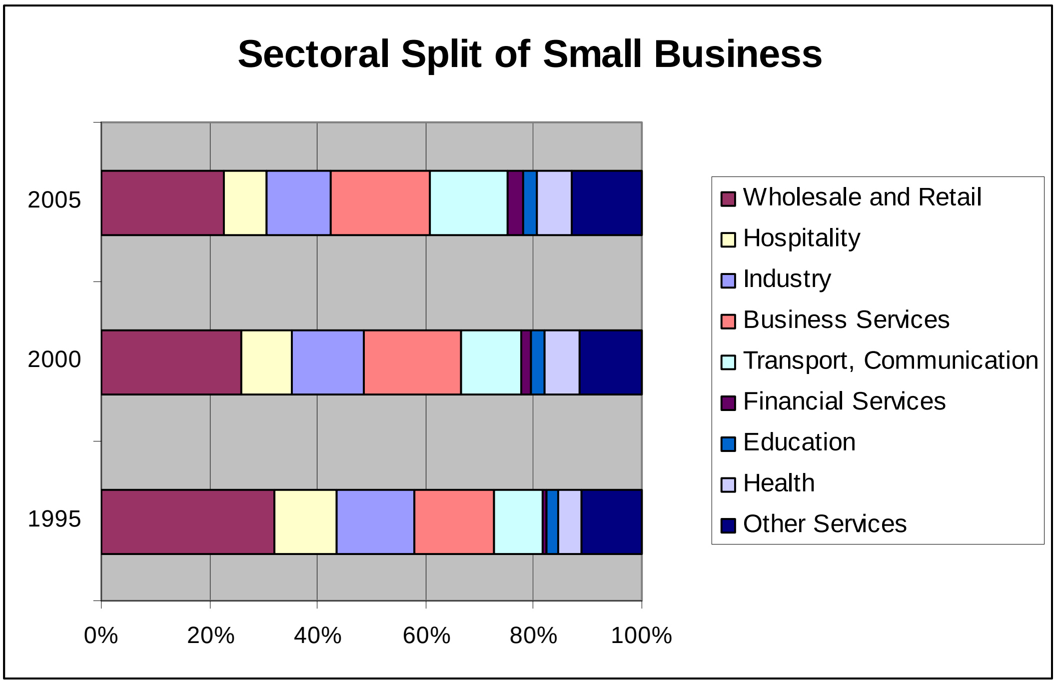
[1] SMEs can be divided into three categories, micro (employees <10), small (employees <50) and medium (employees <250). For this paper we will focus on SMEs, defined as all firms with less than 250 employees in both services and industry, but excluding construction.

[2] Another 75,000 people (2003 data) are employed in medium-sized industrial enterprises (between 50-250 employees). However comparable data for employment in medium-sized service companies are not available.

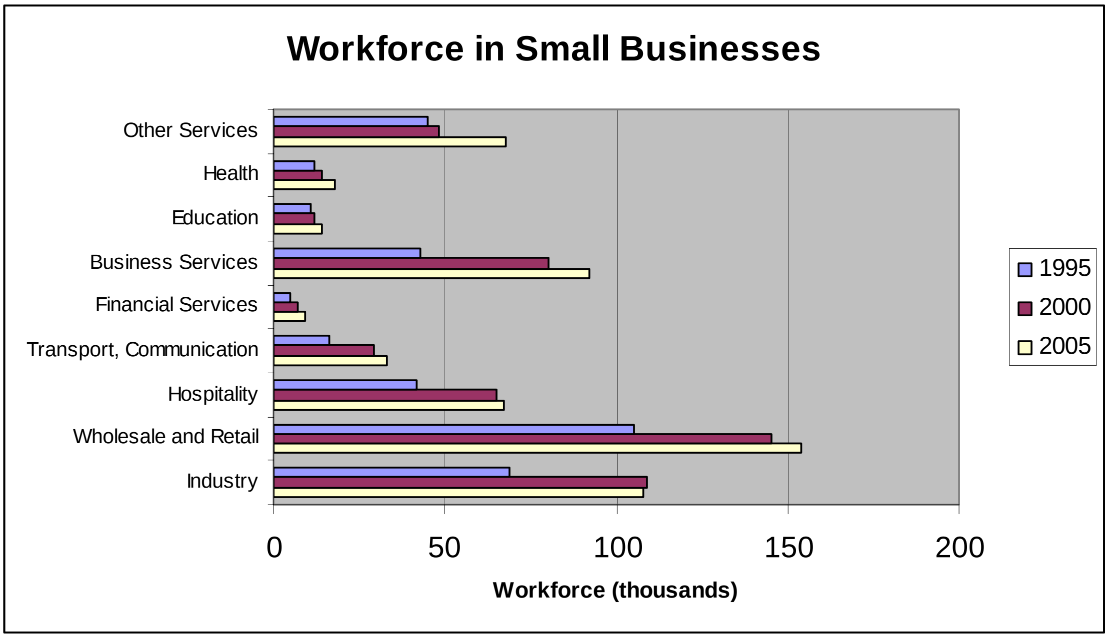
II. DATA ANALYSIS

In 2005 there were approximately 187,000 non-construction small businesses (250,000 including construction) in Ireland.[3] 664,000 people worked in small businesses, which is 46% of the total private sector non-agricultural workforce. The workforce of small enterprises has increased by 90% from 1995. With regard to legal form, 70% of small businesses are sole traders, 18% are limited companies and 12% are partnerships.



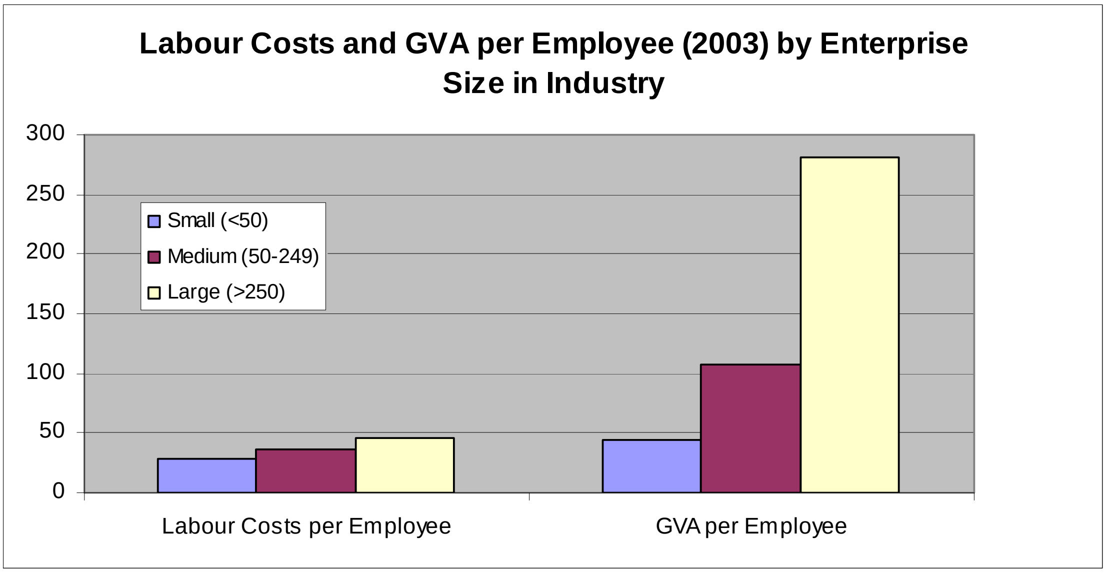
The sectors that saw the greatest numbers of new enterprises created between 1995 and 2005 were transport, communication, financial services and health. SME numbers were either static or declining in industry, wholesale and retail and hospitality.

3 Much of the data on small enterprises is taken from *The Economic Impact of Small Business in Ireland – by DKM Consultants for Forfas*. This report focussed on small companies (<50 employees) rather that the whole SME sector, but its findings are still useful.



Unsurprisingly, given the strong economic growth experienced in Ireland in the period concerned, employment in all sectors increased between 1995 and 2005. Business services, other services and wholesale and retail sectors saw particularly strong growth while employment in industry declined marginally between 2000 and 2005.

Information on gross value added (GVA – the value of output produced less intermediate consumption such as materials, fuels and services), exports and labour costs are available for all industrial SMEs (between 3 and 250 workers) while they are only available separately for services SMEs with less than 50 employees. Therefore the results are presented separately here.



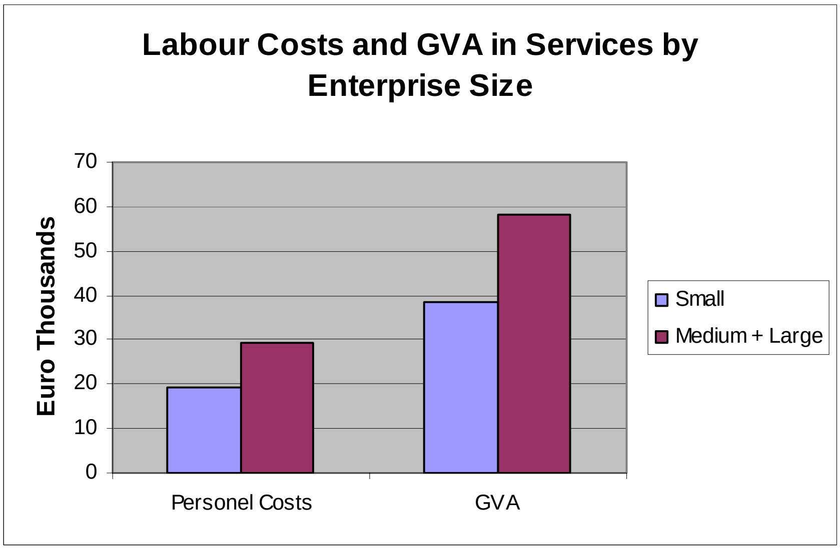
In 2003 the average cost to the enterprise of engaging a worker in a small industrial firm was almost €28,000, in a medium-sized firm it was almost €37,000 while in a large industrial firm it was over €45,000. Gross Value Added from industrial SMEs was €10.6 billion in 2003, 25.2% of total industrial GVA. However the difference in GVA per worker across different firm sizes was considerably greater than the range in labour costs, ranging from €45,000 to €280,000. International productivity comparisons show that small Irish industrial enterprises are average performers, whereas Irish medium-sized enterprises perform very well.[4] While this comparison may be distorted by the presence of large multinational firms, it does suggest that small industrial SMEs are more labour intensive and therefore more likely to be sensitive to rising labour costs than larger companies.

Industrial SMEs are considerably less export intensive that larger firms, they only export 50% of their average turnover as opposed to 85% from large industrial firms. This is slightly lower than in 2000 when industrial SMEs exported 51.8% of their turnover.

As previously stated, data on services are not sufficiently disaggregated to give a separate breakdown for medium-sized enterprises. Using available data shows that the differences between small firms and larger firms with regard to personnel costs and GVA per worker

[4] Report of the Small Business Forum – Forfas 2006

is less pronounced in services than in industry. This likely reflects the fact that services tend to be more labour intensive in general than manufacturing. International comparisons from the Small Business Forum suggest that the productivity of Irish services firms with less that 50 workers has generally been low compared to other countries, while the performance of medium-sized enterprises is better. In relation to services exports the only available data indicate that 4%, or €277 million worth, of services exports came from small enterprises with between 20 and 49 workers.



III. ISSUES FACING THE SME SECTOR

There are a number of problems that are highlighted repeatedly by SMEs and their representative bodies. These include**:**

- Costs of doing business
- Access to finance
- Regulatory burden

Each of these is addressed in the following sections.

The cost of doing business

The rising cost of doing business in Ireland has affected all companies. ***Local authority charges*** and development charges levied by local authorities are often raised by business groups as examples of higher costs within the public policy sphere. Rising labour costs (discussed above) ***energy costs,*** and ***waste disposal charges*** are of course also affecting small businesses.

Access to finance

Lack of early stage finance consistently emerges as a key gap in the market for innovative start-up firms. The bulk of European SMEs access capital in the form of bank debt, which can be difficult to source and may be inappropriate for their development, particularly by those seeking to engage in research and development or with high growth potential. Venture capital is a method of providing the equity financing of unquoted companies - typically SMEs - from seed to expansion stages of investment. However, some firms continue to report difficulty in accessing venture capital for expansion. Venture Capital is discussed in more detail in Section IV.

Regulatory burden

While Ireland is ranked fairly high internationally in terms of the ease of doing business, it must be recognised that the burden of regulatory compliance is not spread proportionately across companies of different sizes. Several UK studies have demonstrated that average compliance costs fall as business size increases, and that the disproportionate cost of compliance is the primary issue affecting small business.

There are several areas where the regulatory burden are an issue for small companies. Of interest to the TSG, SMEs are also faced with what they regard as burdensome regulations with regards to the operation of the VAT and Corporation Tax systems. The following issues, which were highlighted in the *Small Business Forum Report*, illustrate the situation for SMEs.

VAT Registration Thresholds

Traders established in the State and making supplies in the State are obliged to register for VAT where certain turnover thresholds are exceeded or are likely to be exceeded in any continuous period of twelve months. Under EU law, with which Irish VAT law must comply, Member States may only increase thresholds in line with inflation. The current thresholds which where increased last year (by €2,000/€4,000) are:

- €27,500 in the case of a person supplying services.
- €55,000 for persons supplying goods.

The Small Business Forum Report recommended that the VAT registration thresholds be increased to €35,000 for services and €70,000 for goods. In considering increases in the thresholds the following considerations arise:

- If the thresholds were increased in line with the Consumer Price Index since 1994, this would result in the €27,500 threshold being increased to €36,516 and the €55,000 threshold being increased to €73,032. The costs involved would be €23.1m and €55.1m respectively, amounting to a total cost of €78.2m in a full year. This could remove up to 11,800 businesses from the VAT net.

- Ireland currently has the third *highest* registration thresholds in the EU, after the UK [stg £61,000 (€90,500)] and France [€27,000/€76,300] - some Member States have no registration thresholds and require all firms to register irrespective of their turnover. Wherever a threshold is set, there is a question of competition between firms which are just one side or the other of the threshold.

VAT Cash Basis of Accounting

The Small Business Forum Report also recommended raising the threshold for using the cash basis of accounting for VAT (for non-retail businesses) from €635,000 to at least €1 million.

VAT is normally accounted for on the basis of invoices issued i.e. VAT is payable on the total sales invoiced in the relevant period, regardless of whether or not the trader has been paid for the supply in that period. However, since the introduction of VAT in 1972, certain traders could opt to account for VAT on a cash receipts basis i.e. the trader is not required to pay VAT until payment for the supply is actually received.

The VAT cash accounting option assists a significant number of firms and focuses in particular on small firms in the critical area of cash flow. From 1 September 1997, the annual turnover threshold for eligibility for the cash basis of accounting for VAT was increased from £250,000 to £500,000 (€635,000). At that time, it was expected that up to 9,000 traders would benefit from the resulting cash flow gain. However, the Revenue Commissioners have indicated that only around 20% or 1,750 of these traders took up this facility despite extensive publicity at the time.

Enquiries in this regard by the Revenue Commissioners indicated that some traders claimed that it was simpler and more efficient for them to analyse their debtors when accounting on the invoice basis and that it was administratively not worth their while to make the changeover to the cash basis. Furthermore, it would be costly to change back to the invoice basis once the turnover threshold for the cash basis had been exceeded.

If the threshold was increased in line with the CPI since 1997 it would now stand at some €875,000. Increasing the threshold would have a sizable once-off cash flow cost in the year of introduction. For example, increasing the threshold to €1 million, if all the 7,600 extra traders who would be potentially able to use the facility availed of it there would be a potential cost of €146m. However, if it is assumed that only 20% to 25% of them avail of the facility the estimated once-off cash flow cost in the year of introduction would be of the order of €30m to €35m. Given the low take-up of this facility there would not seem to be a strong justification for significantly increasing the threshold.

Preliminary Payment of Corporation Tax

Companies are obliged to meet their corporation tax liabilities by reference to accounting periods. They are required to file a return of their profits 9 months after the end of the accounting period. Tax payment arrangements for accounting periods ending on or after 1 January 2006 are as follows[5]:

- Preliminary tax to be paid 1 month before the end of the accounting period;

[5] All corporation tax payable in a month is payable not later than the 21st of that month.

- Balance of tax to be paid at the time of filing of the return 9 months after the end of the accounting period.

Preliminary tax for an accounting period is the amount of tax that, in the opinion of the taxpayer, is payable for the accounting period.

Interest on any balance of tax payable

Where the final liability for the accounting period exceeds the preliminary tax paid, any balance of tax payable will carry interest back to the original due date (1 month before the end of the accounting period) if certain thresholds are not met as regards preliminary tax. The general rule is that the balance of tax payable will carry interest back to the original due date unless preliminary tax paid for the accounting period is not less than 90% of the final liability for the accounting period. This, however, is subject to a number of exceptions.

One of the exceptions is that, in the case of small companies, interest will not be payable on any balance of tax paid if the preliminary tax paid is not less than the lower of 90% of the final liability for the accounting period and 100% of the final liability of the preceding accounting period;

Small companies

A company is regarded as a small company as respects an accounting period if the final corporation tax liability of the preceding accounting period does not exceed €50,000. It should be noted that the status of "small company" is determined by the amount of a company's corporation tax liability and not by reference to its size. The Small Business Forum recommended that the threshold required to be a small company be increased from €50,000 to €100,000. It is estimated that such a change would involve a cash-flow cost in the region of €6M for a full year. It may be necessary to make any such change subject to some conditions in order to reduce the scope for manipulation by companies.

IV. GOVERNMENT RESPONSES

The Government has engaged in a wide range of initiatives to support the SME sector. Some of these are discussed below.

Government Agencies

There are several government bodies which provide some form of supports to companies in the SME sector. These include Enterprise Ireland, County Enterprise Boards, FAS and Fáilte Ireland.

Enterprise Ireland is the main agency charged with supporting indigenous companies and it has a number of schemes aimed at helping them develop. In 2005 Enterprise Ireland allocated €161 million to Irish industry. *Enterprise Ireland* provides support to SMEs either as a direct investment/grant aid, or through advice and by introducing SMEs to industry networks. Supports are targeted on a regional basis with the BMW region getting the maximum level, with other regions getting less and the Dublin region getting the lowest level.

A Sample of Enterprise Ireland Schemes

- Productivity Improvement Fund

  This fund aims to improve the competitiveness of Irish companies through investment in new technology and training. Funding for capital and technology acquisition varies from 27.5% to 50% of eligible expenditure, up to a maximum of €200,000 per company, with 50% of the approved amount in the form of a repayable grant. Funding for training acquisition varies from 27.5% to 50% of eligible expenditure, up to a maximum of €150,000 per company, with 50% of the approved amount in the form of a grant.

- Research, Technology and Innovation (RTI) Scheme

  In order to stimulate R&D performance, companies which engage in R&D can receive funding of up to €650,000, with between €390,000 and €450,000 of this in the form of a grant.

County Enterprise Boards (CEBs) provide advice, training and support to qualifying companies with less than 10 employees. The types of financial supports available include feasibility study grants which can amount to up to €6,350, capital grants, up to a maximum of 50% of the investment or €75,000, whichever is the greater, and employment grants up to a maximum of €7,500 per employee.

Venture Capital

Under the NDP 2001-2006 Enterprise Ireland has €95 million to invest in SMEs, in partnership with private sector venture capitalists. These investments are specifically targeted towards SMEs at early stages of development, requiring small investment amounts (less than €500,000 first round), have a greater regional perspective and are in sectors that are traditionally difficult to finance. This scheme was expanded significantly in May 2006. Enterprise Ireland is investing €175m in a new round of Venture Capital funding, which will leverage an estimated €1bn for investment in start-up, early stage and development stage businesses.

Business Expansion Scheme (BES)

The BES, which is an approved state aid, allows individual investors to obtain income tax relief on investment in a qualifying company, up to a maximum of €31,750 per annum. There is no tax advantage for the company in receipt of the BES but it does make them more attractive for investors wishing to reduce their tax bill. A company can receive up to €1 million in BES funding.

A review of the operation of the BES is currently under way in the Department of Finance. This review will inform decisions in relation to whether the scheme will be continued beyond its current expiry date of 31st December 2006. Using latest figures the cost to the exchequer in terms of taxes foregone due to the BES was €21.1 million in 2004.

Seed Capital Scheme

This is part of the BES. Its objective is to help employees, unemployed persons and those made redundant to acquire additional funds with which to start their own business. As with the BES, eligibility for SCS relief is restricted to approved enterprises. The size of the tax refund depends on the amount of the individual's investment and is limited to the tax the individual has paid in previous years, subject to an investment limit of €31,750 per annum for six years. Using latest figures the cost to the exchequer in terms of taxes foregone because of the SCS was €2.6 million in 2004.

The two schemes are due to expire on 31 December 2006 and are currently being reviewed by the Department of Finance in conjunction with the Department of Enterprise, Trade and Employment and the Revenue Commissioners in advance of Budget 2007. As part of this review, companies availing of the schemes have been surveyed. Revenue records data have also been analysed and studies carried out by Enterprise Ireland.

The majority of companies who have responded to the survey regard the schemes very positively and are strongly in favour of extending them.

The report of the Small Business Forum also supports the continuation of the schemes and has suggested a number of changes including increases in the company limit, the investor limit, and the type of income against which relief can be claimed.

As the schemes are State aids, any such extension would require the approval of the European Commission. Should the schemes be extended, the main questions arising would be whether to increase the amount a company can raise above €1 million and whether the limit at which individual investors can claim tax relief should be increased above €31,750. The scope of qualifying activities and various other issues have also been raised.

All of these issues and proposals will be examined in the course of the review having regard, in particular, to the essential purposes of the schemes, the likely additional costs to the Exchequer, the implications for other schemes as well as the potential for tax planning.

Better Regulation

The Government is also committed to reducing the burden of regulation, which can fall disproportionately on SMEs. As part of this process, ***Regulatory Impact Analysis (RIA)***, an evidence-based approach that allows for the systematic consideration of the benefits and costs of a regulatory proposal to the economy and society, is being increasingly used by Government. RIA will give special consideration to business impacts, especially in respect of SMEs.

Some regulatory changes have already been enacted in order to reduce the administrative burden on small business.

In June 2006 legislation was passed raising the turnover threshold above which a company is subject to a statutory audit from €1.5 million to €7.3 million, the maximum allowed by EU law.