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Dan O'Brien - Friday, September 7, 2012

Are exports about to drop?

Ireland's exports – so long a growth engine – face heightened risks and this could have profound implications for tax revenue, our debt-to-GDP ratio and our return to sovereign debt markets

QUESTIONING Ireland's economic performance during the Celtic Tiger era was often met with accusations of "talking down the economy" and worse. The curtailment of debate on the sustainability of the boom led, among other things, to a collective sense of invulnerability and blindness to the many flashing warning lights.

Today, it appears obvious that, during the pre-2008 period, observers succumbed to "groupthink" – the phenomenon where consensus views go unchallenged. A greater willingness to challenge consensus robustly and relentlessly may be among the most important lessons to be learnt from the crash.

One consensus view to emerge in the post-crash era is that the export sector of the economy has performed very strongly. This is certainly not incorrect.

Exports have been the only source of growth since 2008. And they have grown from an already high level – the Irish economy is among a handful in the world where exports exceed GDP.

But when measured by what is arguably the most important indicator for a small trade-dependent economy – share of the world market – the picture is much less positive.

According to World Trade Organisation data, Ireland's share of the global goods and services exports has fallen by more than one quarter since it peaked in 2002 (see panel, bottom).

If gains have been made in restoring competitiveness lost during the bubble era, there is still some considerable distance to travel.

Of greater concern than insufficiently strong rates of export growth is the risk that exports will start to shrink.

Part of the consensus on exports is that as most competitiveness indicators are moving in the right direction, the foundations of the sector are becoming stronger, and that this will allow for further growth in the future.

There is no doubt that some of the competitiveness previously lost has been regained, but many other factors determine how much is earned from exports. There are a number of identifiable threats to export earnings in the future.

How vulnerable are pharmaceutical exports – currently worth one-third of GDP and by far the largest single category – to the major patent-related changes in the industry globally?

To what extent are exports – and services exports in particular – artificially inflated by multinationals' tax-minimising accounting practices and how could they be affected by changes in the Irish and/or US tax regimes?

Finally, if a significant fall in export earnings were to take place, what impact would this have on the real economy and public debt sustainability?

If most manufacturing sectors have lost world market share over the past decade, the pharmaceutical industry has been a spectacular exception. By last year, a quite astonishing 7.2 per cent of the world's cross-border spending on medicines was booked in Ireland.

The accompanying chart shows that, by the widest measure, the pharmaceutical and chemicals sector generated export earnings of €56 billion last year. This represented a 40 per cent increase in just five years. No other goods exporting sector has come near a rate of growth of this kind.

But not only is it unlikely that such rates of growth will continue, they may well be reversed, and in a relatively short time frame. The reason is the expiration of patents on many of the big-selling drugs made in Ireland.

There is no doubt that global sales of these drugs will fall sharply in value as generic manufacturers offer their own versions at a fraction of the cost. What is in question is what the holders of expired patent decide to do in response.

Chris Van Egeraat, an academic specialising in the sector at NUI Maynooth, believes the choice for "big pharma" is either to continue production and slash prices to compete with new entrants to the market or to exit the market altogether.

If major firms plump for the first option, overall export earnings will fall sharply; if some halt Irish production altogether, earnings will fall even more precipitously

and some of the 30,000 people employed in the sector will face the grim prospect of redundancy.

The experience of the IT hardware sector over the past decade is a salutary reminder of how global market conditions in a given sector can change a great deal in a relatively short period.

During the 1990s, Ireland became a global centre of computer manufacturing.

By 2001, the broad export sector which includes IT hardware was Ireland's largest foreign trade earner, with the value of goods shipped abroad reaching €38 billion.

By last year, that figure had crashed to €10 billion as the industry either moved offshore or succumbed to competition from east Asia where much of the world's IT hardware is now manufactured.

If the pharmaceutical sector were to experience a similar scale of decline, €40 billion would be taken off the headline total export figure.

A second broad threat to the export sector comes from possible changes in the Irish and/or US corporation tax regimes.

It has long been known that multinational corporations, which account for 90 per cent of Irish exports, book as much profit as possible in Ireland to take advantage of its relatively low 12.5 per cent corporation tax.

By using a (lawful) practice known as transfer pricing they can ensure that profits generated in other countries end up in Ireland. Central to transfer pricing is inflating the value of goods and service produced, and then exported from this jurisdiction.

US Department of Commerce figures suggest the phenomenon may be particularly marked in the IT sector.

The latest figures show that in the three years to 2009, US IT companies' Irish subsidiaries accounted for 35 per cent of sales of all US affiliates' European sales.

In no other sector did Irish-based affiliates so dominate US companies' European sales. This could point to a greater prevalence of transfer pricing in this sector.

According to Irish data, computer services now account for the 40 per cent of total services exports and were valued at €32 billion last year, twice the value recorded just six years earlier. They were largely unaffected by the global downturn in 2008-09 and have continued to register strong growth since 2010.

Michael Hennigan, a cold-eyed Malaysia-based observer of Irish affairs, has repeatedly highlighted what he sees as the Potemkin nature of the services export boom – in the IT sector in particular – pointing out that it has not been reflected in job creation.

If much of the growth in exports is an accounting mirage, raising Ireland's corporation tax rate and/or change to US code could result in large falls in the headline export earnings. Changes in both countries' corporate tax regimes could take place in the coming years.

If the euro zone moves towards fiscal union, there will certainly be calls from some member states for harmonisation and/or a floor for profits taxes.

Although it should be noted that in some fiscal unions, such as Switzerland's, the regions retain most corporate tax raising powers, some powerful EU member states have strong views on the matter.

In a grand bargain to save the euro, it would not be at all improbable that Ireland would be obliged to raise its corporation tax rates.

It is curious that, despite near paranoia in Ireland about changes in Europe which could threaten Ireland's tax advantage, change to the US corporation tax regime poses as big a threat but is barely remarked upon.

Pressure for change is growing and proposals, including bipartisan ones, are being made with increasing regularity. And the pressure for change is likely to rise further. Not only is the average US rate one of the highest in the world, it is, almost uniquely, charged on companies' worldwide incomes, rather than solely on income generated in America.

Together, these features are putting US companies and the wider economy at a competitive disadvantage which is growing larger as global corporation tax rates trend downwards.

If reform is enacted, the threat to Ireland would come less from a lowering of the US headline tax rate by a few percentage points and more from a change to the income subject to tax.

Currently, a deferment clause means that tax is paid only when the income is repatriated to the US.

This incentivises companies to keep profits generated overseas indefinitely. Many analysts believe up to $2 trillion would return to the US if the tax was reformed.

US figures put investment in Ireland at $188 billion last year. If even one-fifth of that were to be repatriated, it would result in very considerable outflow of capital from the Irish economy.

How likely is reform of America's corporate tax code?

Donald Marron, who served in the Clinton administration and is now director of tax policy at the Urban Institution, a think tank in Washington DC, told The Irish Times: "Corporate tax reform will be difficult politically, despite bipartisan desire to lower the top rate. The international aspects of any potential reform, including repatriation, remain unsettled. I do not see a consensus yet."

Dan Mitchell, a tax expert at the free market Cato Institute and a former congressional staffer, also believes that the chances of major reform are low, but he thinks the outcome of November's US presidential election will be important.

"If Romney wins, I think a one-time repatriation is very likely, and it may even be a better-than-even chance in a second Obama term," he told The Irish Times.

Reassuringly, the corollary of the argument that the headline export rates are artificially inflated means that the impact on the real economy and employment in particular might be limited if they were to disappear. But the impact of a decline in exports (in either the services or pharma sectors) on tax revenues would likely be greater.

Last year total corporation tax revenue stood at €38 billion, a large chunk of which was contributed by US companies. With the budgetary position so parlous, a loss of revenue of even €1 billion would be serious.

But perhaps the biggest potential change of a sharp fall in exports is perceived debt sustainability.

Currently, the troika, the Government and most forecasters believe public debt will peak at €200 billion, or 120 per cent of GDP.

That is already close to the outer limit of what is considered manageable.

If headline Irish export earnings were to fall by €20 billion, it would slash about one-eighth off nominal GDP, all other things being equal. That would push the debt/GDP ratio to 140 per cent of GDP. Such a figure would very likely kill off investor interest in Irish government debt.

All these risks flowing from a big fall in export earnings remain just that for the moment – risks. But they are real.

Being blind to them won't make them go away.

THOUGHTS ON IRISH TRADE: HEADLINE FIGURES DISTORT REALITY

MICHAEL HENNIGAN, FOUNDER OF FINFACTS.IE

"The rise in headline services exports in the past decade has been impressive and most economists have reacted by suggesting it reflects a 'move up the value chain' while various ministers have lauded the rise in knowledge-sector jobs.

"However, an analysis of the data shows very large headline figures for services exports have limited impact on the real economy. In 2011, for instance, about 9,500 Irish workers were responsible for 73 per cent of all services exports by my calculations.

"Moreover, there has been no significant rise in employment, as illustrated by the computer services sector which has seen no growth in employment levels since 2000.

"The rise in headline services exports largely reflects the tax strategies of US firms, whereby services revenues generated in other countries are booked in Ireland. This does not reflect real economic activity but is merely an accounting exercise.

"The problem with the exaggerated headline numbers is that that they are viewed as fact by policy makers, allowing real and serious challenges to be ignored."

THOUGHTS ON IRISH TRADE: OVER-RELIANCE ON PHARMACEUTICALS

DR CHRIS VAN EGERAAT, LECTURER IN ECONOMIC GEOGRAPHY AT NUI MAYNOOTH

"Irish merchandise exports are dominated by pharmaceuticals. The sector is therefore crucial to the Government's export-led recovery strategy. The main threat to this strategy is the 'patent-cliff' – six of the world's 10 biggest-selling drugs coming off patent are at least partially produced in Ireland. The latest merchandise export figures reflect the start of the patent cliff impact.

"Patents are normally filed first in the home country of a given multinational corporation. As a result they usually first expire in the home country also. This is reflected in Irish chemicals exports to the US in the first half of 2012, which fell by €2.6 billion, or 30 per cent, compared to the same period in 2011.

“That is unprecedented in recent years. As the relevant patents have not yet expired in non-US markets, the full effect has yet to play out. It is impossible to predict the precise effect, but it is clear that the impact of these developments on Irish exports will be in the order of billions of euro. For example, a 30 per cent drop in exports to the EU would translate in a €10billion drop in chemical exports on an annual basis.”

IRELAND’S SHARE OF WORLD TRADE: KEY BENCHMARK A CAUSE FOR CONCERN

THE WORLD Trade Organisation in Geneva tots up the value of every countries’ exports and imports of both goods and services. Among other things, this allows economies to benchmark their trade performance against other countries. Perhaps the most important way of doing this is by measuring share of the world market. Any business worth its salt thinks about how much of its potential market it is capturing. Analysing market share allows companies to assess how much opportunity there is out there.

It can also be a warning system – falling share is usually a sign that something is going awry. Ireland Inc’s share of the world export market gives cause for concern. From 1980, Irish exporters took a growing share of a (fast growing) world market. Growth rates of goods exports exceeded the global average in the dismal 1980s and 1990s before accelerating further during the Celtic Tiger years. From a share of the world market of half of 1 per cent in 1980, Irish exporters tripled their slice of the pie by the turn of the century.

But the trend since 2002 has been very different. In all but one year until 2011 Irish goods exporters lost share. By last year their slice of the world market was 0.7 per cent, half the 2002 share and not far off that of the 1980s. The performance of Ireland’s services exporters from the late 1990s has been very different from their widget-making counterparts.

From 1997, when the share stood at 0.5 per cent of the world market, sales of services to foreigners exploded, growing more than fivefold in just a decade (some of that is accounted for by better statistics). By 2007, more than one dollar in every $40 paid for cross-border services across the world accrued to Ireland. Since then, however, there has been no further growth in share and it stood at just over 2.6 per cent last year.