NERI Submission to the White Paper on Enterprise

Introduction

The justification for enterprise policy is that a society's overall well-being is enhanced by a faster, albeit environmentally sustainable, rate of inclusive economic growth over the longer term, and that properly designed enterprise policies can potentially facilitate growth as a tool to tackle societal challenges. Supports for enterprise are justified to the extent that the society-wide benefits outweigh the deadweight, opportunity and other costs of providing that support.

Economic growth comes from the accumulation and use of labour and capital inputs (i.e. investments in people and infrastructure and elimination of employment barriers) combined with improvements in the productivity of labour and capital arising from on-going scientific progress and technological change. Sustainable growth in per capita output depends on improving labour productivity.

A country's long-run productive capacity is ultimately a function of its innovative capacity. A country's innovative capacity is, in turn, a function of:

(A) education levels and human capital;

(B) prior investments in innovation infrastructure and in machinery and equipment;

(C) the cost of knowledge production, diffusion and use;

(D) the quality and diversity of capital markets and

(E) government policies that support public and private research (R&D).

The economy's innovative capacity determines the level of innovation and the rate of technology diffusion.

Enterprise policy should focus on maximising the economy's overall innovative capacity. In particular, the government should increase public funding for both basic and commercially driven research in order to increase the production, diffusion and use of new ideas. This should be accompanied by the establishment of more attractive and secure career paths for researchers and by the establishment of deeper collaborative linkages between government, firms and universities.

In addition, government should meaningfully increase investment in education, personal development, and skills, particularly in early years learning and measures to eliminate childhood poverty. Human capital is an essential input and complement to innovation.

Where capital markets are not well-functioning there is a case for some form of state support to provide patient long-term finance to support innovative effort and technology diffusion. Crucially, this concept of the state as investor entails taking equity stakes in high-risk and high-potential start-ups with an additional but less important secondary function of providing conditional[1] loans for private enterprise.

Mariano Mazzucato talks about the state as primarily an 'innovative mission-oriented investor of last resort' not a 'lender of last resort' and a 'sharer in risk-taking' and not just a 'reactive fixer of market failures'. For example, she emphasises the need for a mission-oriented approach to the enormous but necessary economy-wide transition to net zero, and she notes the unique ability of the state to provide the patient, long-term, strategic, committed finance necessary to make that transition.

Policy interventions

The use of tax expenditures as a tool of public policy should be minimised. In general, tax incentives tend to negatively affect growth by distorting allocative efficiency, by creating inefficiencies in

[1] For example, conditions related to minimum environmental and labour standards.

production and consumption, and by diverting economic activity toward rent-seeking behaviour. Tax expenditures also tend to carry significant deadweight and are generally regressive.

Tax expenditures are therefore only justifiable where there is clear structural evidence of inherent market failure. In general, subsidies for business (including agriculture) can also be deleterious to long-run growth to the extent that they skew economic activity and distort resource allocation. Enterprise policy evaluation should be based on the broader 'societal' impacts and not just on the private firm impact.

However, the characteristics of knowledge and the potential for gains from knowledge spill-overs suggests that 'new ideas' will be produced by the market at a level below the socially optimal rate. Therefore, there is a justification for government intervention to encourage R&D activities either through direct provision, through subsidies or through tax expenditures.

Overall, we see three broad policy areas where appropriate government intervention could potentially enhance the long-run productive capacity of the economy via supports for enterprise. These areas are:

1. Increasing the rate of high potential start-ups (HPSUs) and raising equity finance for HPSUs.
    - The State should meaningfully increase public spending on R&D including funding for basic research, and should also meaningfully increase funding generally for STI courses and activities, for the career progression of STEM researchers, and for administrative and related supports aimed at facilitating establishment of HPSUs.
    - In addition, the government should establish an independent state investment bank focused on investment in high potential start-ups via a combination of equity stakes and low interest loans. The investment bank could use its size and wider societal remit to focus on radical high risk and high reward activities that might otherwise

struggle to receive private financing. Nascent firms often have difficulty securing finance due to their lack of a track record.

- The incentive for entrepreneurs to establish a HPSU would be enhanced by the provision of a stronger social safety net including social insurance based on previous earnings and strong judicial protections in the event of failure. Having these safety nets in place would make risk-taking more attractive and therefore increase the rate of new business formation.

2. Incentivising research, development and innovation.

    - Policy should incentivise experimentation by firms in new ideas, technology adoption and in new business models and practices. There is scope to reform the R&D tax credit to better target SMEs and to reduce the administrative burden and uncertainty around the use of this relief.
    - Even so, direct subsidies for innovation are likely to be of greater value for early stage companies and to carry less deadweight loss. Subsidies should form a larger component of the R&D fiscal incentives offered to SMEs.
    - In addition, the government should seek to better develop the national system of innovation (NSI) and widen innovative capacity. This would entail deeper and more systemic collaboration between firms, academia, think-tanks and government including via access to researchers, secondments and demonstrations, and information campaigns. Small firms will particularly benefit from access to the human and technical capital embodied in university and government connections.
    - R&D carries significant upfront costs and has a high probability of failure. Ireland's size means it must inevitably specialise in a limited selection of technologies and

activities. The government should explore how best to establish collaborative linkages between the key actors in Ireland's NSI and the key NSI actors in other countries. Cost sharing and cross-fertilisation of ideas between countries and regions opens up additional possibilities for frontier innovation and for greater technology diffusion.

3. Attracting and retaining human capital and diffusing technologies to laggards.

   - High levels of human capital within SMEs will facilitate technology diffusion. There is therefore merit in considering fiscal supports to incentivise key employees to join or stay with a HPSU. For example, a tax relief on share-based remuneration. Such a relief should only be available to early stage firms.
   - Greater funding should be available to incentivise firms to invest in the human capital of their workforce and to incentivise engagement with academics and business networks in order to facilitate a higher rate of technology diffusion.
   - Impediments to labour supply and skills bottlenecks should be removed where appropriate. This entails not only reducing the costs associated with employment such as the cost or lack of availability of childcare, but also reducing the barriers to labour market mobility within Ireland and inward migration into Ireland (e.g. housing costs).
   - A social insurance system based on income replacements would enable a better allocation and more efficient use of human capital by facilitating a more considered and better match of skill-set and job function.

Facilitating churn

Supports for the continuation of existing businesses have little merit in terms of generating new ideas and new innovations, or in terms of promoting a vibrant churn of business entry and exit. A high rate of business churn is an important element in the ongoing process of generating innovation and technology diffusion.

For example, the enormously generous reliefs for CAT business and agriculture relief, as well as the CGT retirement relief and CGT relief on death, have little or no economic justification. The opportunity cost of such fiscal supports for business continuation means fewer fiscal resources are available for targeting high potential start-ups.

Policies that prolong inefficient firms (e.g. inheritance tax and capital gains tax exemptions) should be discontinued. Policymakers should seek to avoid trapping resources in underperforming firms.

Policy should also seek to reduce barriers to firm entry and exit and avoid 'lock-in' to particular economic activities. This should include generous bankruptcy laws that do not penalise failure and that encourage young firms to exit the market and entrepreneurs to 'try again' differently.

Finally, there should be generous and ongoing supports for life-long learning and education in order to enable workers to learn new skills and adapt to new technologies. This will facilitate workers transitioning to employment or entrepreneurship in growing sectors of the economy. This is essential from a just transition and therefore political economy perspective but also makes sense from a productive and innovative capacity perspective.