

**NESC REPORT NO. 76**

**THE ROLE OF THE FINANCIAL SYSTEM  
IN FINANCING THE TRADED SECTORS**

**Price: £4.20**



## NATIONAL ECONOMIC AND SOCIAL COUNCIL

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# NATIONAL ECONOMIC AND SOCIAL COUNCIL

## *The Role of the Financial System in Financing the Traded Sectors*

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F. Roche  
P. Dowling  
M. Walsh  
A. Hourihan  
J. Murray

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**PART I**

**THE COUNCIL'S COMMENTS ON THE ROLE OF THE FINANCIAL  
SYSTEM IN FINANCING THE TRADED SECTORS**



## SECTION 1

### INTRODUCTION<sup>1</sup>

1.1 In its review of industrial policies the Council stated that industrial policy should focus on promoting the development of businesses which would have the capacity to survive and grow in internationally competitive markets. At that time (1982) it was stated:

“Achievement of this objective will require a more selective industrial policy in which priority would be given to the development of internationally trading indigenous industry and foreign companies incorporating certain desirable characteristics”.

The lack of a strong indigenous internationally trading industrial base was seen to reflect a variety of factors, including historical development, the level of marketing effort, product development, quality of management and financial structure.

1.2 In the course of its review of industrial policies the Council had intended to consider the role and contribution of the financial system to industrial development. As circumstances did not allow this to happen at that time, the present study was undertaken after completion of the main review. The Council decided to undertake this study in the belief that the operation of the financial system would be a key factor in future industrial development. It was anticipated that there would be an increased need for high risk capital, long-term funding instruments and a greater technical expertise applied to the decisions of lending and investing institutions. It was noted also, that significant changes were taking place in the financial system, e.g., the establishment of venture capital institutions, the growth in the importance of long-term savings institutions.

1.3 The project was undertaken with the following terms of reference:

“To examine the role of the financial system in financing the

<sup>1</sup> Following discussions by the Economic Policy Committee and by the Council these comments were drafted by Paul Turpin, Secretary to the Council.

traded sectors. To study the financing needs of traded sector businesses and the ways these needs are met. To make recommendations on ways the banks, insurance companies, pension funds and other financial institutions could make a greater contribution to the development of these businesses".

In addition, a list of issues to be addressed was drawn up under three main headings: the financing needs of industry; the current policies of financial institutions; and policy options (Appendix A).

#### **Method of Approach**

1.4 The project was done in two stages. The first stage involved the commissioning of five members of the Faculty of Commerce in University College Dublin, led by Dr Frank Roche, with Professor Michael Walsh, Mr Patrick Dowling, Dr John Murray and Mr Tony Hourihan, to prepare a background study on the terms of reference. A steering group, chaired by Mr Liam Connellan with members drawn from the NESC, financial institutions, Government Departments and agencies was set up to monitor the consultants' study. The membership of the steering group is attached as Appendix B.

1.5 The consultants met regularly with the steering group and presented a first draft of their report to the Group in October 1983. The report was subsequently revised after discussions with the Steering Group and, subsequently, the Council's Economic Policy Committee. It is based on the data collected during July and August 1983. The final revisions were completed in March 1984. The report is attached as Part II below. The Council and the Steering Group believe that the report contains valuable information and that it should be published. The views expressed in the report, however, are the personal responsibility of the authors.

1.6 The second stage of the project was the preparation of the Council's own comments on the subject area. These views are set out in the following paragraphs. They include consideration of events which took place after the consultants completed their main analysis, in particular the introduction of a tax incentive for long term investments in industry and the curtailment of "bondwashing".

1.7 The Council comments are structured around the three main aspects of the financing of industry. *Section 2* looks at the financial performance and structure of Irish industry, seeking to identify where gaps arise in the availability of finance. *Section 3* comments on the financial system, looking at the cost of finance, the availability of types of finance and the relationship between the financial system and industry.

*Section 4* comments on the role of the State. The State is the dominant supplier of risk capital to the traded sectors. It has a major influence on the pattern of investment flows through the financial system. This section also includes a discussion of tax incentives for investment in long-term risk capital.

1.8 Finally, the Council's general conclusions and recommendations are presented in *Section 5*.

## SECTION 2

### THE FINANCIAL STRUCTURE OF IRISH INDUSTRY

2.1 The ability of firms to maintain and expand output and employment will depend on their financial health and their capacity to identify investment opportunities. This will be the context in which they will consider the risk/reward profile of an investment and whether new investment could be profitably undertaken.

#### The Role of Profits

2.2 In their report the consultants state that foreign firms in Ireland have earned a satisfactory level of profits. Indigenous manufacturing companies, in contrast, have had inadequate profits and suffer from a lack of equity investment. The central theme of the consultants' recommendations is the desirability of increasing the flow of equity into manufacturing industry. They caution, however, that any sustained increase in equity investment would require an improvement in the current low levels of profitability of indigenous industry.

2.3 While there will be varied opinions on what constitutes an appropriate level of profitability, it is possible to state a number of basic criteria for the assessment of profit adequacy. *First*, an investment will not take place unless the expected return is greater than the cost of funds to the promoter. *Second*, an investment will not take place if more attractive alternative opportunities exist for the promoter's funds. *Third*, the expected level of return must rise with higher levels of risk. In considering investment in traded sector projects this requires, as a minimum, that public policies should not have the effect of making investments in the traded sectors less attractive than investments in other sectors. A case could be made for designing policies to provide a positive bias towards investment in the traded sectors. This is an option which arises in the discussion of the role of the State in Section 4.

#### The Measurement of Profits

2.4 There are serious data problems with the measurement of profitability. Aggregate measures of profitability also tend to conceal the wide variations between different economic sectors and types of firms (within manufacturing industry). Data from the US Department of

Commerce shows that US firms, the main source of overseas investment, have achieved average rates of return of around 30% from their investments in Ireland. There are two main reasons why the profits of foreign subsidiaries are likely to be higher than the average return on indigenous manufacturing investment. *First*, the full costs associated with the development of products and markets are not usually incurred in Ireland. The low rate of tax on manufacturing industry will also act as an incentive to use intra-firm transfer prices with a view to maximising the profits accruing to the subsidiaries located in Ireland. *Secondly*, the foreign firms locating in Ireland are generally firms with products for which a strong market already exists and are attracted to Ireland because of its location within the EEC, and the financial incentives offered. In contrast, most indigenous traded sector firms are faced with the heavy costs of new product and market development and are very small by international standards.

2.5 There are two important recent sources of information on the profitability of indigenous industry: the Financial Executives Association Survey (FEA, 1983) of public companies and the consultants' own sample survey of the financial performance of companies in 1978 and 1982. Both surveys identified low levels of profitability in the firms surveyed. The FEA Survey, more limited than the consultants' survey in that it was based on 41 publicly listed companies, and concluded that for the twelve months to January 1983 "profit margins were the lowest in ten years... the debt level is now unduly high because of the poor profitability of many companies." Profit before tax measured as a percentage return on total assets was 4.4% in 1982, having declined steadily from 10.6% in 1973. Table 1 shows that during the same period there was a general weakening in the financial structure of the companies. The decline in profitability resulted in an increased debt servicing burden.

2.6 The consultants' survey was based on the financial performance of nearly 600 indigenous manufacturing firms which were either internationally trading or had the potential to do so. The results showed that between 1978 and 1982 profit margins had declined substantially. Profit before tax as a percentage of total assets declined from 8.5% in 1978 to 2.4% in 1982. The large subsequent increase in manufacturing productivity in 1983 would have facilitated improvements in profitability in that year. The data does not allow, however, any statement on the 1983 profitability of indigenous firms.

2.7 The consultants conclude from their review of company financial performance that manufacturing industry has had difficulty in attract-

Table 1  
Financial performance of public companies<sup>(a)</sup>

	1973 <sup>(b)</sup>	1978	1980	1982
<i>Profit before tax</i>				
as % of sales	7.9	6.1	4.4	2.9
as % return on total assets	10.6	9.6	4.4	4.4
Returns on equity	22.2	19.2	12.9	8.8
<i>Leverage</i>				
Total debt to total assets %	52.3	50.2	49.4	49.6
Interest cover (Times)	6.1	6.4	3.4	2.8

Notes: (a) The results are based on a survey of the annual accounts of 41 listed non-financial companies.

(b) The results are for the year ending on 31 January of the succeeding years, i.e. for 1982 it is the twelve months to 31 January 1983.

Source: Tenth Annual Report of the Financial Executives Association, 1983.

ing equity funds due to its low level of profitability and the high returns which could be earned on alternative low risk investments. They believe that the higher returns available from alternative investments result largely from tax biases.

### Financing Investments

2.8 There are four main types of finance which are used to finance industrial investment: internal funds, borrowings, State grants and equity participation. The level of internal funds available for investment will reflect the profit experience of the firm, the tax regime and its dividend policies. The level of borrowing will depend on the rate of interest charged, the capacity of the firm to service debt and the other criteria operated by the lending institutions. The information gathered in the consultants' survey suggests that the key consideration of lending institutions is the ability of borrowers to offer security against loans.

2.9 From the two main sources of investment by third parties – State grants and equity participation – clearly grants, which are virtually a free equity injection are the most attractive of all forms of finance and will be sought to the maximum available. Private equity participation, however, involves a wider sharing of the control and profits of a firm. Both forms of finance are appropriate to higher risk investments. The consultants' report shows that high levels of debt financing result in

an excessive financial burden on many traded sector ventures.<sup>1</sup> Typically new start-ups experience negative cash flows during their first three to five years. As a consequence significant debt financing with the need to service regular interest payments is inappropriate to new high risk ventures. The extent of the debt burden and, as a result, the lack of capacity to service borrowing for new investment is highlighted by calculating the interest cover of the firms covered in the survey, which had fallen to an average of 1.7 in 1982.

2.10 The consultants, on the basis of their survey and interviews, did not identify a general lack of finance for the traded sectors. They believed, however, that there was a shortage of two types of funding in the financial structure of firms, i.e., equity and long-term debt.<sup>2</sup> In summary, firms were found to be overly dependent on debt and inappropriately structured to invest in new ventures.

2.11 A lack of *private equity investment* is vividly illustrated in the case of the new ventures in the IDA Enterprise Development Programme. Table 2 shows the typical financing profile of these firms. Private equity on average accounts for only 12% of finance while total borrowing, on which interest payments and capital repayments have to be met, is unrealistically high, at 56%, for ventures which will in their start-up years have to invest heavily in new product development. The remainder of the finance (32%) is provided by the IDA in the form of grants. However, the IDA also guarantees half of the borrowing with the result that the State's exposure amounts to 60%. On reviewing these figures, the consultants state that the EDP projects had a totally inappropriate financial structure.<sup>3</sup>

2.12 The consultants suggest a number of reasons for the general lack of equity investment. They believe that more attractive risk/reward opportunities are available to private investors outside of manufacturing industry. A further obstacle to increased equity investment is the

<sup>1</sup> In looking at the financing of investment in manufacturing, a distinction must be drawn between indigenous and foreign-owned companies. While foreign firms will utilise grant aid, tax-based and other form of lending to assist in financing their investments, their level of profits together with the funds available to their parent companies, make it possible for them to maintain strong financial structures without recourse to third party equity participation in Ireland.

<sup>2</sup> The long-term fixed rate finance provided through the arrangements between the EIB and the ICC is a notable exception to the general position.

<sup>3</sup> The Managing Director of the IDA has stated that in view of the recent "tax incentive to encourage venture capital" the Authority will be reviewing the possible reduction in IDA exposure in order to encourage a greater degree of private equity participation (Address to Leinster Society of Chartered Accountants 5 April 1984).

Table 2

## The financing profile of small firms

Source of finance	IDA programme classification	
	Enterprise development %	Small industries %
Promoter's equity	12	25
Borrowing		
- IDA guaranteed	28	-
- Other	28	39
Grants	32	36
Total	100	100

Source: IDA Annual Report, 1982.

reluctance of many promoters to sell part of their enterprises to outside investors. This reluctance may be encouraged where there is a ready availability of bank finance and grant-aid. Finally, the consultants state that the quality of financial management is a contributing factor to poor financial structures with many small firms seriously lacking in financial expertise. Management quality was the main factor contributing to the varying performance of firms within sectors.

#### Council Comment

2.13 The Council agrees with the consultants that there is a shortage of equity investment in indigenous industry. It also agrees that more attractive risk/reward ratios for investment in traded sector businesses would be likely to result in increased private equity investment. The Council considers the merits of the consultants' recommendations to improve the flow of equity investment to traded sector firms through changes in tax incentives for investment in Section 4, below.

2.14 The Council agrees that, as a first step, it is desirable not to discriminate against investment in traded sector firms through the tax system. There are two ways of removing discrimination: (i) removing the reliefs from the presently favoured areas; or (ii) providing similar reliefs for investment in traded sector businesses. The Council believes that, given the difficulties arising from an already narrow tax base, the former approach is in general more desirable although individual cases may give rise to particular circumstances. The question of providing positive discrimination in favour of investment in traded sector firms in the context of the present tax system is discussed in Section 4.

2.15 Outside equity participation is seen by many entrepreneurs as the least desirable form of finance. It would be inappropriate, however, for

the State to compensate for unnecessarily low levels of equity through increased grant aid, loan guarantees, etc. There are also likely to be many positive aspects to third party investments as they will often bring with them complementary management skills and an increased commitment to expanding the firm's output and markets. The Council believes that, in general, where State aid is offered, it should be accompanied by an equal or greater amount of private equity investment.

2.16 The policies and attitudes of the financial institutions and of the owners of traded sector firms also have an important impact on the flow of investment. The role of the financial institutions as equity investors is discussed in Section 3.

## SECTION 3

### THE FINANCIAL SYSTEM

3.1 A key question to be asked regarding the financial system is whether it could be expected to promote higher levels of industrial investment. The answer to this question requires examination of the internal efficiency of the financial system and the impact of changes in the external environment within which the system operates. The latter aspect potentially raises issues across the whole width of the business environment. For this reason, the Council in its discussion considered and proposed only those policy options which would have a major impact on the role played by the financial system in the development of the traded sectors in industry. In addition, the discussion did not go back over areas of industrial policy which the Council had addressed previously.

#### Cost of Finance

3.2 There are two aspects of the financial system's involvement in industrial investment which should be considered: the potential for reducing the cost of finance to industry and the nature of the relationship between financial institutions and industry. The main factors influencing the cost of finance will be outside the control of the financial institutions. The most important constituent in the level of interest rates charged on loans by financial institutions is the cost of borrowing funds to the institutions. The bank's margin will represent a smaller part of the total interest rate.<sup>1</sup> The impact of improvements in the efficiency of the system on the cost of funds will be limited, however, to reductions in the size of this margin.

3.3 The tax system also has an important influence on the cost of finance. Interest charges on corporate borrowings are allowable against tax. In recent years the very low corporate tax liabilities of many firms has been accompanied by the growth in tax based lending. In this way allowances which could not be availed of by firms have been passed to

the banks. The banks in turn have passed benefits back in lower charges for funds.<sup>2</sup>

#### Relationship with Industry

3.4 As well as being influenced by the cost and availability of different types of funding, the relationship with industry will also reflect the capacity of both parties to understand and appraise in financial terms the investment needs of traded sector ventures. The consultants found that the appraisal of loan requests by lending institutions placed the main emphasis on security rather than the expected cash flow from a project. While the investment requirements for replacement will be relatively straight-forward, the appraisal of investments connected with new product development or market penetration are likely to provoke differing responses from bankers.

#### The Financial Institutions: the Banks

3.5 The financial system can be seen as the means by which flows of savings and investment are balanced between four sectors: the corporate sector, the public sector, the personal sector and the overseas sector. In Ireland, the expenditure requirements of the corporate and public sectors have required net borrowing from the personal sector and from overseas.

3.6 The financial system consists of financial institutions and financial markets. The institutions include banks, life assurance companies, pension funds, building societies and hire-purchase finance companies. The banking sector is dominated by the four associated banks, whose total assets are as large as the combined assets of the remaining licensed and State-sponsored banks (Table 3). Over the last decade there has been a marked growth in the importance of non-associated banks including banks which have specialised more in providing advances to manufacturing industry.

#### Council Comment

3.7 From the perspective of the lending or investing institution the emphasis on security may represent an explicit policy or a necessary criterion where the expertise for a more sophisticated appraisal of the project is not available to the institution. The consultants state: "The more a bank knows about a sector the less the risk associated with lend-

<sup>1</sup> It is not possible to give an exact figure for the margin between the average cost of funds to a bank and the rate of interest charged to borrowers. On the one hand a significant amount of funds controlled by retail banks will be in non interest bearing current accounts. On the other hand banks will be dependent on interbank market for funds to varying degrees.

<sup>2</sup> The *Commission on Taxation* (1982) stated - "the banks pass on almost all of the tax savings arising from tax-related lending operations to borrowers" (p. 389). Notwithstanding this, the Commission in its second report stated "that artificial preference share financing and Section 84 lending are expensive and highly inefficient forms of incentive" (p. 105).

**Table 3**

**The relative size of Irish banks**

Bank classification (1)	No. of institutions	Total assets within the State (1982)	
		£m	As % of associated banks
<i>Licensed private banks</i>			
Associated	4	6,482	100
Merchant	7	1,784	27.5
North American	5	893	13.8
Industrial	11	1,317	20.3
Other	18	986	15.2
<i>State-sponsored banks</i>			
Savings	5		
Development and rescue	3	1,060	16.4

*Note:* (1) Bank classification is taken from Central Bank list of financial institutions.  
*Sources:* *Central Bank Annual Report*, Statistical Appendix, Part II Spring 1983. Annual Reports of State-sponsored Banks.

ing to individual business within that sector and the less the bank must emphasise security". It would follow that there is likely to be a shortage of funds for investment and lending in new ventures if the main emphasis of lending institutions to financing requests is placed on past performance and asset backing.

**Regulation of the Banks: the Bank Cartel**

3.8 In their report the consultants recommend the dismantling of the bank cartel with the objective of improving the service offered by the banks. They believe that the cartel restricts the development of a more competitive financial system which would result in improvements being passed on to the banks' customers.

**Council Comment**

3.9 The bank cartel arrangements apply to the four Associated Banks only and have involved the maintenance by them of common arrangements governing interest rates, bank charges for specific services and working hours. These arrangements have been subject to Central Bank regulation, the need for which in the public interest was particularly evident when the Associated Banks were faced with less competition from other financial institutions. The Council is aware that, in the interest of competition, the Central Bank has for some time been favourably disposed towards dismantling the cartel arrangements in a manner consistent with the continued maintenance of confidence in Irish banks. The Council notes that the Bank has, in fact, already

initiated action in this respect, in the area of charges for bank services, and is currently considering proposals for more flexible methods of deciding on the timing and extent of changes in Associated Banks' interest rates.

3.10 The Council would endorse the consultants' view that the dismantling of the cartel, or common arrangements, would not significantly affect the overall level of interest rates in the economy. These are determined by developments on external financial markets and domestic macroeconomic forces and conditions, particularly the former. The Council also notes the consultants' view that decartelisation is unlikely to lead to any significantly greater volume of credit being available for lending in total or to specific sectors. It is not clear to the Council in these circumstances how decartelisation would specifically benefit the financing of traded-sector businesses. Nevertheless the Council is sympathetic, in principle, to the idea of decartelisation in the interest of promoting more effective competition in banking generally.

**Extension of Area of Central Bank Regulation**

3.11 The consultants also recommend the placing of all deposit-taking financial institutions under the regulation of a single authority which, they suggest, should be the Central Bank. This recommendation is made in the interest of promoting more competition between financial institutions and of mitigating (the mainly fiscal) distortions which adversely affect the risk/reward ratio as far as equity investment is concerned. However, the consultants themselves recognise that the regulation of all deposit-taking institutions by the Central Bank would not, of itself, necessarily increase the sources of funds for investment in industry.

**Council Comment**

3.12 In the Council's view, it is not clear that subjecting all deposit-taking institutions to a common regulatory authority would necessarily lead to removal and/or avoidance of distortions, which the consultants identify as primarily fiscal. Consequently, the benefits which might accrue to the traded sectors from such action would require to be more clearly identified.

3.13 As part of this recommendation, the consultants have recommended that 'offshore' banks who lend into Ireland should be subject to regulation by the Central Bank. The consultants have recognised that, at present, non-resident banks lending into Ireland normally seek an exemption from the Moneylenders Acts for their activities, and domestic borrowers from such non-resident banks are required to obtain exchange-

control permission for the transactions. The Central Bank's surveillance and control procedures are confined to *resident* banking institutions by reason of international practice.

It would seem, therefore, that it would not be practical to extend the surveillance by the Bank of non-resident banks in the manner indicated. The Council understand, in any event, that lending to the private sector by non-resident banks is not significant (at about 8%) by reference to the amount of private-sector loans outstanding to resident banks.

#### The Non-Bank Financial Institutions

3.14 From the perspective of industrial investment the institutions of most interest are (a) the long-term savings institutions and (b) the venture capital companies. *The long-term savings institutions* include life assurance companies, pension funds and, in part, the building societies. Building society funding, however, is almost entirely directed at home ownership and is not directly relevant to the financing of the traded sectors.

3.15 The life assurance and pension funds offer a significant potential source of investment in industry. The most important investment outlets for these funds, to date, have been Government securities and property (Table 4). In 1982, the total assets of life assurance companies in Ireland were equal to £1.4 billion. It has been estimated that pension funds are of a roughly similar magnitude and that the combined annual cash flow from the two sources is between £350 and £400 million.<sup>3</sup>

Table 4

Investment flows of pension funds and life assurance companies, 1982	
Funds	£m
Pension funds	350
Life assurance companies	—
<b>Direction of investments</b>	
Gilt	55%
Properties	30%
Equities	10%
Cash	5%

Source: IDA Annual Report, 1982.

<sup>3</sup> Stokes, Kennedy, Crowley, *Risk Investment in the Development of Irish Manufacturing Industry*, IDA, 1982.

Only between 10% and 15% of the total investment from the funds is in equities. This is in stark contrast to the position in the UK where pension fund investment in equities represents nearly 80% of total investments. The Irish situation reflects two main factors: the scarcity of suitable equities and the large Government borrowing requirement.

3.16 The consultants state that "in general, pension funds do not provide long-term funds for industry". They believe that there are two ways the investment funds could make a greater contribution to the development of the traded sectors: firstly, through taking over part of the IDA property portfolio; secondly, through providing more information on investment decisions to the fund contributors.

3.17 The consultants describe *venture capital* as the "funding required to get a concept from the feasibility study stage into commercial production." They refer to it as the second stage of financing, after seed capital investment, in the growth of a company. It is generally seen as an investment on which no dividends or interest are paid for several years and on which a significant capital gain can subsequently be realised, it is therefore a form of finance appropriate to high risk new ventures. In the relative absence of private venture capital investment in Ireland, the State, through the IDA, has been the main source of venture capital in Ireland.

3.18 The role played by venture capital in the US has been cited as a major factor in the rapid growth of new high technology companies. Changes in the rates of capital gains tax are believed to have been a major cause of fluctuations in the supply of venture capital there. A major constraint to a continuation of the rapid growth of the venture capital market since the mid-1970s is seen as the shortage of managerial talent required of successful venture capitalists.<sup>4</sup> In the United Kingdom there is not yet a large venture capital market. A recent Bank of England review stated that such a development would probably have considerable benefits for the economy: "venture capitalists are natural intermediaries between institutional investors who have funds but lack the human resources for active involvement in management, and rapidly growing businesses who often lack both".<sup>5</sup> In France, the Government is seeking to promote increased flows of risk capital directly through state financial institutions or in joint ventures with private investors.<sup>6</sup>

<sup>4</sup> Fortune 1982, "Do we have too many venture capitalists?", 4 October.

<sup>5</sup> Bank of England, 1982, "Venture Capital", *Quarterly Bulletin*, December.

<sup>6</sup> *Financial Times*, 16 November 1983.



3.19 In Ireland there are now several private companies providing venture and development capital. The main investors in these companies are pension funds and other financial institutions. None of the companies solicit funds directly from individual investors.

#### **Council Comment**

3.20 The growth in assets controlled by the pension and insurance funds has been one of the most important developments in the financial system over the last twenty years. The consultants' recommendation that members of funds should receive more information on investment decisions merits consideration by the appropriate parties. The specific recommendation to invest in the IDA property portfolio raises two wider issues. Firstly, the costs and benefits to the State would require careful examination. The current market for industrial property could make it difficult to sell large amounts of IDA properties.

3.21 A second consideration is the extent to which the investment policies of the institutions can be integrated more closely with the objectives of industrial policy. In considering the apparent mismatch between the funds available and the lack of investment in industry consideration must also be given to the rationale of pension funds and the role of trustees. A trustee's duty is to manage a scheme's assets solely in the interests of its beneficiaries. Their primary objective is to secure the maximum return for their pensioners.

3.22 While the Council recommends a more active involvement in industrial investment by the pension funds it recognises that, by international standards, the opportunities for this investment are still very limited. The case in favour of a more active direct involvement by the funds in industrial investment is based on two of their main characteristics: their large size and their long-term perspective. The size of the funds means that their investment decisions will have a strategic impact on firms. It also follows that their own performance will be heavily dependent on the further development of industry. The long-term investment requirements of the funds also corresponds with the opportunities facing firms who must accept relatively long pay back periods on investments designed to establish their products on international markets.

3.23 The Council believes there is a need to integrate more closely the need for the long-term savings institutions to find investment outlets and the objective of the Government to promote investment in traded sector businesses. This would require an outline of the means by which it was intended to finance Government borrowing in the medium

term and the outlook for industrial investment as seen by the Government. It would also require discussions between Government and the relevant financial institutions on the role of the latter in the context of actual and expected available resources. In this context it would be appropriate to consider periodic consultations with the pension and assurance industry by the Government.

#### **The Financial Markets**

3.24 The banks and other financial institutions are linked together and with the sectors outside the financial system by a series of markets. There are three main financial markets: the securities market, the money market and the foreign exchange market. As this study is concerned with the promotion of equity investment the main focus is on the securities market, which includes company securities and Government gilts, and is mainly located in the Stock Exchange.

3.25 Over the last decade activity on the Stock Exchange-Irish has been marked by the decline in the importance of the private investor and the dominance of the institutional investment funds. The main trading in the market has been in Government gilts. In the first quarter of 1983 the turnover in Government gilts was equal to 61% of the total transactions and 99% of the total value.

3.26 The consultants believe that the Irish Stock Exchange has been irrelevant as a source of capital for manufacturing industry. While accepting that a number of reasons for this are outside the control of the Exchange, the consultants also state "the Exchange has not been innovative in responding to the needs of Irish industry".

3.27 They believe there is a need to develop a sense of awareness of the particular needs of the Irish industrial and investment community: "There is now a tendency to abdicate responsibility to London". They recommend the establishment of a more autonomous Irish Stock Exchange Council, representative of all spheres of investor interest.

3.28 In a submission (August 1983) to the then Minister for Industry and Energy, the Committee of the Irish Stock Exchange state:

"The number of companies on the Irish Stock Exchange has been declining steadily during the last ten years. . . . This decline is not a measure of failure by the Irish Stock Exchange, but is the result of the recession, the impact on companies of political policies in regard to competition and the removal of protections, and taxation aspects. . . . The Irish Stock Exchange, through its links with

the Stock Exchange in London, is an integral part of the most respected and regulated Stock Exchange in the world."

#### Council Comment

3.29 The Council agrees that many of the reasons for the peripheral role of the Stock Exchange in the development of traded sector businesses are outside the influence of the Stock Exchange. The small size of the market, with 6 companies accounting for around 65% of the total capitalisation of the 77 listed companies in 1983, is a major constraint to more active trading.<sup>7</sup>

3.30 The main areas where the Exchange can influence its own effectiveness are (a) in the efficiency of its own practices and (b), in its sensitivity to the needs of potential new entrants. On the former the Stock Exchange has argued that flotation expenses on the Unlisted Securities Market have not been high relative to the expenses associated with raising capital elsewhere. In contrast, it has been argued by critics of the Exchange that the lack of new flotations reflects the (perceived) disadvantages which include the costs associated with a listing and the onerous requirements with regard to trading.

3.31 The sensitivity of the Stock Exchange to the particular needs of new entrants is difficult to measure in the context of the generally weak financial performance of Irish industry in recent years. It is obvious that some of the publication requirements of a stock exchange listing would have brought an additional transparency to the workings of some private companies. The Exchange would also be expected to grow in importance, in the future, with a strengthening of the industrial base. The introduction of incentives for investment in equity would be likely to increase pressures on enterprises to grow to a size suitable for a stock exchange listing.

3.32 The Council believes that it would be desirable to take measures to ally the Exchange more closely with the needs of industrial development. It believes that there is scope for the Exchange to be more receptive to the needs of Irish industry. It is clear that a combination of the actual situation and how the Exchange is perceived by firms has contributed to the peripheral nature of the Exchange's role in industrial development. The Council recommends the establishment of an advisory

<sup>7</sup> There has also been a fall in the number of companies on the Exchange. Much of this contraction in numbers of limited companies has been due to mergers and takeovers, which normally have only a small effect on total market capitalisation.

committee representative of the main interests, including the regulatory bodies, the State's industrial policy and financial agencies, the Stock Exchange members and industry to make recommendations on the future development of the Exchange as a source of new industrial investment.

## SECTION 4

### THE ROLE OF THE STATE

4.1 The State plays a major role in the financing of traded sector ventures through, (i) grant aid, tax concessions, subsidised loans, loan guarantees and equity investments, (ii) influencing the general economic environment and (iii) investments in state-sponsored firms in these sectors. In 1982 it is estimated that the total of public expenditure on industry, together with tax foregone from tax based lending and new loan advances to industry from state-sponsored financial institutions amounted to a total funds flow of about £745 million (Tables 5 and 6).

4.2 Within the total expenditure on industry, the single most important item of public expenditure has been the amount of IDA grants to industry, equal to £141 million, in 1982. An important aspect of this figure is the extent to which it is concentrated on new investment. In that year, on the basis of planned industrial investment of £582 million, the IDA made a commitment to provide £260 million in capital and training grants, a figure equal to 45% of the total investment.

#### Provider of Risk Capital

4.3 Through its heavy grant commitment to new industry the State has filled a role which would otherwise have been appropriate to equity investment. The financing profile of small firms was shown in Table 1. The need for a very heavy involvement by the State and the existence of poor financial structure has already been referred to in the case of the Enterprise Development Programme projects (Section 2). In that programme, promoters' equity accounted for an average of only 12% of the total assets of these ventures.<sup>1</sup> The total debt is 56%. The consultants, referring to the high level of debt, state:

"There is four times as much debt as equity in the EDP companies. A more appropriate financial structure for these new ventures would be to have four times as much equity as debt."

<sup>1</sup> The policy of the IDA towards promoters' equity is now being revised and a higher percentage of private investment will be required (see also footnote 3 to Section 2).

Table 5

State funds for industry: public expenditure, 1982 (£m)

	Current	Capital	Total
<i>Development</i>			
(1) Industrial Development Authority	24.45	211.0	235.45
(2) SFADCo	7.17	21.64	28.82
(3) Udaras na Gaeltachta	3.16	15.4	18.56
(4) National Enterprise Agency	.83	—	.83
(5) National Development Corporation	—	—	—
(6) Total	35.61	248.04	283.7
<i>Marketing</i>			
(7) Coras Trachtala	13.47	—	13.47
(8) Irish Goods Council	.94	—	.94
(9) CBF	1.59	—	1.59
(10) Total	16.0	—	16.0
<i>Training</i>			
(11) AnCO	77.57	12.13	89.7
(12) CERT	2.67	—	2.67
(13) IMI (including ESF monies)	.99	—	.99
(14) Youth Employment Agency	—	—	—
(15) Enterprise Allowance	—	—	—
(16) Total	81.23	12.13	93.36
<i>Research development of technical assistance</i>			
(17) IIRS	11.94	2.09	14.04
(18) Kilkenny Design Workshop	2.64	—	2.64
(19) Irish Productivity Centre	.62	—	.62
(20) NBST	3.32	—	3.32
(21) National Micro-Electronics Facility	.14	1.04	1.18
(22) Total	18.66	3.13	21.8
<i>State companies</i>			
(23) ICSET, Irish Steel, Cemici Teo, NET	—	13.55	13.55
<i>Other Departmental expenditures</i>			
(24) Forestry — Grant to Chipboard Products	—	.04	.04
(25) Labour — Employment Incentive Scheme	2.6	—	2.6
<i>Industry, Trade, Commerce &amp; Tourism</i>			
(26) — Export guarantee scheme	1.03	—	1.03
(27) — Export credit	2.07	—	2.07
(28) — Shipbuilding subsidy	.73	—	.73
(29) Currency exchange losses (ICC)	—	1.4	1.4
(30) Total	6.43	1.44	7.87
TOTAL (6) + (10) + (16) + (22) + (23) + (30)	157.9	278.3	436.28

Notes: Expenditure definitions are based on "Comprehensive public expenditure programmes", Department of Finance, 1983.

Table 6

## State funds for industry: loan finance and tax concessions, 1982

£m	£m
<b>Tax based lending (cost to Exchequer) <sup>(1)</sup></b>	
Section 84/Preference	63 <sup>(2)</sup>
Leasing	92 <sup>(2)</sup>
<b>Total</b>	<b>155</b>
<b>Loan Finance – new advances</b>	
Industrial Credit Company	140
Foir Teoranta	14
<b>Total</b>	<b>154</b>
<b>TOTAL FUNDS FLOW TO INDUSTRY</b>	
• Public expenditure	436
• Tax based lending	155
• Finance	154
<b>Total</b>	<b>745</b>

**Notes:** (1) The Export Prolits Sales Relief (EPTR) and the low (10%) corporation tax on manufacturing industry are not included as they represent long-term policy commitments, made in advance of many start-up and investment decisions. The national cost of the EPTR was estimated equal to £96m in 1982, while the equivalent figure for the 10% manufacturing tax was £17m and £39m in 1983.

(2) The figure is inflated by the once-off decision to bring forward corporation tax payments. Tax returns in 1982 were in effect, for an 18 month period. The estimated figure for 1983 section 84 lending/preference share financing is £50m. The tax forgone through leasing by financial institutions is estimated to have been £60m in that year.

### Incentives for Equity Investment

4.4 In considering ways the financial system might promote investment in industry, the State will have a key influence in determining the attractiveness of alternative investment opportunities. The return on Government gilts will often be a point of reference against which the return and risk attaching to other investments will be measured. The dominant role of gilts in the portfolios of investment funds was shown in Table 4. In their report, the consultants state that over the last decade there were, on average, higher after tax returns on investments outside indigenous manufacturing industry. In their view, these higher returns were due mainly to tax biases which favour investments in Government gilts, property and insurance linked unit trusts. The overall result was that the risk/reward ratios facing investors provided a bias against investing in the areas of greatest value to growth in output and employment.

4.5 The consultants recommend removal of certain incentives for

investment in non-manufacturing investments, viz, the tax exemption of capital gains on Government gilts, the abolition of the special incentive for new rented dwellings ("Section 23") and the equal tax treatment of interest paid by all deposit-taking institutions. They also recommend the introduction of new tax incentives for investments in new ventures.

4.6 The consultants also recommend a new incentive for equity investment:

"To encourage the flow of equity capital to manufacturing industry tax write offs should be available for individual and corporate investors who provide equity capital for industry. The degree of income tax write off should decline from 100% in the case of seed capital, to 75% for new venture enterprises to 50% for investment in all other existing developing companies."

The consultants indicated the following objectives for their proposal: (a) the promotion of a wider involvement in industry; (b) recognition of the different life cycle needs (i.e., seed, venture, development and mature stages) of a company; (c) a resulting reduction in both grant and debt levels.

### Council Comment

4.7 Since the first draft of the consultants' report, the Minister for Finance has announced the Government's intention to curb "bond washing" on gilts. The tax concessions on rental income have also been restricted. The 1984 Finance Act contains details of a new incentive for individuals to invest in manufacturing industry and in certain service undertakings. In considering the merits of new incentives for investment in industry the Council believes that four main issues must be taken into account:

- (i) the use of tax incentives to promote investment in traded sector businesses;
- (ii) the nature of eligible businesses;
- (iii) the form and amount of tax relief;
- (iv) the cost to the exchequer.

These issues should be analysed in the context of the objective to bring about higher levels of output and employment than would otherwise exist through the most cost effective use of public funds. It would also be desirable to promote closer ties between individual investors and

industry. A note on tax incentives for the promotion of equity investment in some other countries is contained in Appendix C.

### The Use of Tax Incentives

4.8 The importance and value of a new tax incentive for equity investment must be seen in the context of the current tax system which combines a narrow base with high marginal rates. The Council has stated previously its view that there is a need for reform of the tax system. Should the tax system be reformed, for example, in accordance with the recommendations from the Commission on Taxation, the case for a particular tax incentive to encourage equity investment would be much weaker, as the marginal rate of the tax paid by investors would be lower. The Commission referring to the direct taxation system said (July 1982): "the extraordinary range of exemptions and deductions from personal income for tax purposes which narrow the tax base and result in higher tax rates should be abandoned. Only standard personal allowances given in the form of tax credits should remain." In its second report, *Direct Taxation: the role of incentives*, the Commission noted the proposal in the 1984 budget statement to introduce tax relief for long-term risk-capital investment. The commission recommended:

"If this proposal is implemented it is imperative that the relief be tightly drawn to prevent tax avoidance. We also think that any relief in this area should be temporary."

The following discussion looks at the case for equity incentives in the context of the existing pattern of taxation.

4.9 A tax incentive results in a loss of revenue to the State.<sup>2</sup> Its justification should, therefore, include evidence that it will yield a greater social return than an equivalent amount of direct public expenditure.<sup>3</sup> The presentation of such evidence presents difficulties of measurement as tax concessions are more difficult to control than direct budgetary expenditures. In general the latter are more desirable on the criteria of transparency, accountability and selectivity. The greater potential for selectivity is important in two key areas. Firstly, in the area of industrial

<sup>2</sup>The actual loss to the State is reduced to the extent that extra activity and revenues are generated.

<sup>3</sup>In its review of industrial policies, the Council, in examining the cost-effectiveness of grant aid to industry recommended consideration of part replacement of grant aid through other financial instruments, e.g., loan guarantees, reimbursable equity. While these forms of aid are open to the main criticisms of lack of transparency and accountability levelled at tax incentives, they might also result in significant benefits if some public assistance to industry was replaced by private investment.

promotion there are, even with existing policies, serious difficulties in ensuring that the main focus of aids and concessions is in support of firms in traded businesses. Secondly, tax concessions at an individual's marginal tax rate are regressive.

4.10 The Council believes that an incentive for private equity investment is desirable in current circumstances.\* The Council believes that the operation of the incentive scheme provided for in the 1984 Finance Act should be reviewed after a year on the basis of its operation and in accordance with certain principles. In the first place, the Council believes that any newly introduced incentives should seek to incorporate the criteria of transparency, accountability and selectivity. Other aspects of how an incentive might be designed are set out below.

### Deciding The Eligibility of Business

4.11 An objective of increasing investment in new manufacturing enterprises would correspond with the most significant gap in the financing of industry. A wider eligibility for similar incentives, to include existing industry, could lead to a relative neglect of new ventures. The Council believes there should be a bias in favour of new ventures and expansions of existing firms.

4.12 The introduction of incentives which would apply only to new manufacturing ventures would be unlikely to lead to a large increase in investment in industry. It would not be expensive to the Exchequer, either. For example, a doubling of the equity investment from private sources in the IDA Enterprise Development Programme in 1982 would have required less than £2m. The cost to the Exchequer, if any, would depend on the rate of tax relief and any changes in the amounts of grant aid and loan guarantees. If tax relief were given at the standard rate (35%) the cost of the incentives to the Exchequer would be about £0.7 million. The incentive could be fully financed by a corresponding grant reduction equivalent to 13% of the total committed to the EDP.

4.13 The Council believes that it would be desirable to consider introducing tax incentives for a wider range of traded sector investments than new manufacturing enterprises. A widening in the range of eligible investment areas should involve lower levels of relief for investments in established ventures than for investments in new ventures. The need to introduce incentives for other than new ventures should be seen as a temporary measure aimed at supporting the development of a self-sustaining industrial base. The introduction of a bias into the tax

\*A note of reservation by the ICTU representatives is set out in Appendix D.

system only tackles the symptoms of the more fundamental problem of indigenous traded businesses, i.e., their low level of profitability.

4.14 The experience of other countries would suggest that there have been major administrative difficulties in defining eligible investment opportunities. This arises, in part, from the difficulty which has been encountered in this country also, of controlling tax based incentives. In Ireland, however, selectivity in favour of industry is already established in two important areas: grant aid and the tax system. One definition of eligibility for the purposes of the new incentives would be those firms qualifying under the 10% rate of tax or the Export Profits Tax Relief. A finer tuning would be desirable, however, to ensure funds flowed to the traded sectors.

4.15 The Council notes the concern expressed by the consultants in regard to the problem of co-operatives raising equity capital. Since within the co-operative sector are some of the larger businesses within the State, the Council agrees with this concern. The proposal for the establishment of Royalty Type Bonds, could in the view of the Council, be a useful tool in endeavouring to overcome this problem and the Council believes that the co-operative movement should examine this and other similar ideas as a matter of urgency.

#### Cost of New Incentives

4.16 Estimates of the likely cost of the new incentive can be made on the basis of the likely value of investment opportunities or the supply of funds. A rough estimate of the available opportunities can be calculated for a hypothetical scheme which seeks to replace some of the debt of small grant aided firms with private equity investment. The calculations assume an objective of bringing current levels of equity investment up to the present levels of grant aid through equity investment by third parties. The calculations in Table 7 would suggest total investment opportunities, for third parties, of less than £11.5m in 1982 arising from project agreements with the State promotion agencies.<sup>4</sup> If tax relief at the standard rate were given for investments in the EDP projects and new small firms (domestic and overseas), and at half that rate for existing small firms, the total cost of the incentive to the Exchequer would have been less than £4m. This assumes that the original promoters' equity would not be eligible for the tax relief.

4.17 The amount of money which would be invested would depend on the level and distribution of personal incomes and the attractiveness of

<sup>4</sup>This figure would have to be reduced to allow for: (i) actual expenditure in a year is generally lower than total commitments and (ii) restriction of the relief to traded business.

Table 7

Private equity investment required to match State commitment to small industry investment in 1982

	(1) Grant commitment £m	(2) Promoters equity £m	(1)-(2) Additional matching requirements £m
Enterprise development	4.40	1.65 <sup>(e)</sup>	2.75
<i>Small Industries</i>			
IDA: - New domestic firms	10.25	7.07	
- Existing domestic firms	10.51	7.25	
Shannon Development	4.70	3.24	
All domestic small industries	25.46	17.56 <sup>(e)</sup>	7.90
Total (including international services and overseas small firms)	37.14 <sup>(a)</sup>	25.62	11.50

Notes: (a) These commitments will result in expenditure phased over a number of years. Actual total IDA grant expenditure in 1982 was equal to 80% of total grant commitments.

(e) Estimated from financing profile of small industries given in Table 2.

the investment opportunities relative to other areas. A review of the highest income earners (just over 3,000 persons had declared total incomes over £30,000 in 1980-81) suggests that there would have to be a very high participation from this group for the resulting investment flows to be significant at a national level. A recent calculation of potential funds from this source, in the current year, suggests that total investment of £5m would be a high target.<sup>5</sup>

4.18 Possible alternative investment opportunities are contributions to life assurance funds. These funds, which allow one half of total contributions against tax, up to a ceiling of £2,000, attract contributions from individuals at all income levels. In 1980-81 the total of the contributions allowable against tax was equal to £25.6m, at a cost to the tax payer of £13m. In contrast to life assurance funds an equity investment incentive could offer an earlier realisation of returns, it would not include a specific life assurance contribution in its total, it could provide a higher ceiling on allowable deductions and a more favourable tax allowance. For these reasons it may not be necessary to offer tax relief at the highest rates in order to ensure an adequate flow of private equity investment.

<sup>5</sup>McLoughlin, K., "Business Expansion Scheme - An Opportunity for Growth". Investors in Industry, 1984.

4.19 The Council believes that in designing an equity incentive, priority should be given to ensuring the direction of investment flows in response to the new incentive. The amounts allowable for each individual is a secondary consideration. Concerns regarding the inequitable impact of the incentives should be met through the appropriate reallocation of the Exchequer funds released by corresponding savings in other areas, (ii) the restriction of the top rate of relief to the standard tax rate and (iii) ensuring that the small investor is in full avail of the incentive. The full incentive should be limited to *new* traded enterprises, or new expansions by enterprises of this nature, which have the support of the State's industrial promotion agencies. Full tax advantages should be dependent on holding investments for five years. The level of income allowable against tax should be large enough to allow individual investors to take a significant share in a firm's capital, say £25,000 per individual.

## SECTION 5

### CONCLUSIONS AND RECOMMENDATIONS

5.1 The Council's decision to undertake a study of the relationship between the financial system and the traded sectors represented a continuation of the Council's previous discussions on policies for industrial development. These discussions emphasised the objective of increasing the output from internationally trading high value-added firms.<sup>1</sup> The discussion, in this report, of policy options for the financial system is set in the context of the current macro-economic environment, including a situation of severe pressure on public expenditure. The Council, therefore, considers whether some alterations in the pattern of the State's intervention could lead to a greater share of investment being financed from non-exchequer sources.

5.2 It is clear that changes in the role played by the financial system as a source of external funds for industry would not be a sufficient condition for the successful growth of a company. The conditions of success represent a combination of good products, human resources and costs. It is also necessary to look at the relationship between the financial institutions and traded sector firms from the perspective of both parties. The form of this relationship is heavily influenced by the return on investment achieved by a firm. It is possible, however, that variations in the policies of the financial institutions could make a significant impact on the relative success or failure of a venture.

5.3 The Council believes there are grounds for questioning the nature of the present relationship which has seen a continuing growth in private investment funds without a commensurate increase in private sector investment in the traded sectors. The potential consequences of this mismatch have been modified by increased private investment in Government gilts and increased public expenditure on assisting private firms. The scope for further growth in public expenditure in this area is now severely curtailed. The need to address the mismatch, however, is made more immediate by the requirement to increase the output of an indigenous industrial base which is not now in a position to adequately

<sup>1</sup> Report No. 66, *Policies for Industrial Development: Conclusions and Recommendations*.

fund this development, through either internally generated funds or the main type of external finance available, i.e. short and medium term debt.

### **The Financial Institutions**

5.4 The size of funds controlled by the financial institutions makes it unrealistic to consider the financial system's contribution to the development of industry as merely a passive conduit of funds from other sectors. The actions of banks and the long-term savings institutions have important implications for the development of the economy and incorporate an ability to significantly affect that development. The Council believes that the integral role of the institutions should be explicitly recognised in national economic policy and that this is consistent with the obligations on the trustees of funds to ensure the maximum benefits to the contributors. It recommends that measures should be taken to improve the awareness of the various parties to the needs of industrial development, as an objective of common concern to all parties.

5.5 In general, there is not a shortage of debt finance for industry. In many cases there has been an excessive reliance on this form of finance. The weaknesses in the financing of industry relates, in part, to the management of that finance by borrowers. In their survey the consultants found that fifty per cent of the firms with less than 200 employees had no qualified financial personnel. Financial institutions perceived bad general management as the key factor in the collapse of firms.

5.6 The Council believes there is a need for an increased amount of finance provided in a package which includes measures designed to improve the standard of management. This is a role which has been taken, in respect of new high technology ventures, by venture capitalists in the US. Their role has been described as "a way in which new technology, entrepreneurial talent and management resources are sought out and combined to exploit market opportunities".<sup>2</sup>

5.7 While there is a need to ensure that venture capital is developed in Ireland, the need to contribute to improved management raises issues much wider than those faced by new start-ups. The Council would like to see an acceleration in the trend of financial institutions taking minority equity stakes in firms.<sup>3</sup> Developments of this nature

<sup>2</sup>Bank of England, 1982, "Venture Capital", Quarterly Bulletin.

<sup>3</sup>This will require a greater willingness on the part of corporate shareholders to sell equity stakes to financial institutions.

could be assisted by the development of consortia of financial institutions with the objective of investing in industry. Typically, a bank now faced with a perceived case of bad management by a client borrower has the limited power of exhortation or the extreme power of appointing a receiver in case of default on repayments. The taking of an equity stake through appropriate mechanisms would have the combined impact of improving the financial structure of the firms while ensuring the banks and other financial institutions had a greater commitment to, and capacity to influence, the development of these firms.

5.8 A more active involvement of lending institutions in the need to strengthen the management of firms will require an improvement in the appropriate managerial resources of the banks. Rigid policies which concentrate recruitment at junior levels and emphasise the internal training of staff to develop the skills are likely to be inadequate. The Council believes there is need for much greater interchange of personnel between banks and industry. It believes the value of this is already evident where it has taken place.

5.9 The appointment of appropriate non-executive directors has been found to provide another means for improving the sensitivity of the relationship between the financial institutions and industry. There are available among senior executives and academics many individuals who understand the concerns of financial institutions and who, by serving on the boards of traded firms, could strengthen the relationship between the institutions and traded sector firms in a beneficial manner.

### **The Stock Exchange**

5.10 The Stock Exchange has played a small and declining role in financing Irish business. The main reasons for its peripheral role relate to issues outside its control. The main growth in the traded sectors has come from foreign firms whose shares are not traded on the Exchange. The market has also been too small to offer the span of investment opportunities which would attract large numbers of investors.

5.11 The cost of a stock exchange listing, whether on the main or ancillary markets is an item which comes under the control of the Exchange. There appears to be some perception among industrialists that the costs and additional pressures associated with an exchange listing are prohibitive. Others, including the consultants used by the Council, have argued that the Stock Exchange is not responsive to the particular needs of Irish industry. The Council recommends the establishment of a committee, representative of the main interests, to advise on an enhanced role for the Exchange in the growth of the traded sectors.



### **The Personal Investor**

5.12 The relationship between the personal saver and the investment funded by his savings is a distant one. The main equity purchases are carried out by the institutions as a part of very large investment funds. The main opportunities for direct investment are provided by the Stock Exchange. It is an area which is not only small in relation to the financing needs of industry, but also, where the importance of the individual investor has declined. This is an issue which should be addressed by the advisory committee recommended above. There are also a number of options outside the development of the Stock Exchange for increasing the awareness and commitment of savers to industrial investment which merit consideration: improved information to pension fund holders; venture capital funds raising funds directly from individuals.

5.13 A more fundamental question relates to whether there should be additional tax incentives for investment in industry. The introduction of a new tax incentive adds a further distortion to the tax system and narrows the tax base. However, in the current climate of low private investment and the likelihood that radical reform of the existing tax system will not be undertaken, incentives for risk capital investment in traded sector ventures could have an important and beneficial impact.

5.14 The Council therefore welcomes the new incentive with some reservations.\* It believes there should be a review of the operation of incentive within twelve months of its introduction. In the context of this review the Council proposes the following principles. First, there should be a more favourable treatment of investment in new and expanding ventures than in existing ventures. Relief at the standard tax rate for the former and at half that rate for the latter are proposed.\*\* Second, the Council believes that the cost of the incentive should be financed through a corresponding reduction in other areas of public expenditure on industrial development. Third, relief should be restricted to traded sector businesses. Fourth, the amount allowable for tax relief should be sufficient to allow individual investors to take a significant share in a firm's capital, say £25,000. Fifth, the minimum investment allowable should be low enough to facilitate the small investor.

### **Regulation of the Financial Institutions**

5.15 The consultants recommended measures to improve competition between the financial institutions through the dismantling of the bank

\*The major reservation of the ICTU representatives is set out in Appendix D.

\*\*The Confederation of Irish Industry recommends that more generous tax reliefs be allowed for an initial period until the scheme has been proven to be successful.

cartel and the placing of all deposit-taking financial institutions under the regulation of a single authority. It is not clear to the Council how decartelisation would specifically benefit the financing of traded-sector businesses. Nevertheless, the Council is sympathetic, in principle, to the idea of decartelisation in the interest of promoting more effective competition in banking generally. The subjecting of all deposit-taking institutions to a common regulatory authority would not necessarily lead to removal and/or avoidance of distortions, which the consultants identify as primarily fiscal. Consequently, the benefits which might accrue to the traded sectors from such action would require to be more clearly identified.

### **The State as a Source of Finance**

5.16 The objective of State assistance to industry is to compensate for the difference between the private return and the (higher) social return in the most cost effective manner. The levels of assistance reflect the need to compensate for the difficulties encountered by a late developing economy on the periphery of its major markets. The incentives also reflect the need to compete with the inducements offered in other countries for internationally mobile projects.

5.17 The main options open to the State in the way that it contributes to the financing of industry are:

- (i) changes in the pattern of State investment relative to private investment across different financing needs;
- (ii) a change in the form in which incentives are offered, e.g. the replacement of tax incentives by grants;
- (iii) direct equity investment.

5.18 In its review of industrial policies the Council recommended a finer tuning of State incentives with a view to encouraging firms to build the strengths on which international market share would depend. The particular problems of funding new products, market development and high skill levels were identified. These items are also more difficult to finance than the fixed assets which are in turn more likely to qualify for grant aid. The consultants' survey results would support a relative shift in the direction of aid to non-fixed assets.

5.19 The Council recommends that the introduction of an incentive for investment in risk capital should be accompanied by a corresponding reduction in the State's financing of other items, e.g. grants, loan guarantees. This could involve a reallocation of up to £11m in the budget for industrial promotion.

5.20 In 1982, the IDA paid out a total of £130m in grant aid (92% of total IDA payments to industry), £5m (3.6%) in interest subsidies and £2m (1.4%) for equity shareholdings. This reflects a general policy of not taking equity stakes. Other State equity investments (apart from those made by the Industrial Credit Company) have generally been in the areas of rescue and chronic loss-making enterprises. The National Enterprise Agency and the National Development Corporation have, however, been allocated £10m for capital investment in 1984.

5.21 The main arguments against State equity relate to the contention that (a) it is not appropriate to the State, and (b) that the public sector has neither the experience nor the skills appropriate to commercial risk taking. The main arguments in favour of State equity investment are (a) it would make it possible for the State to receive a higher return from its investments in industry, (b) the involvement of the State is necessary to fill a gap in the industrial investment caused by the long pay back period from many new ventures, (c) the information available to the State can be turned to commercial advantage in some areas.

5.22 The Council recommends continuation of the present situation where the State makes minority equity investments in new firms where this appears commercially justified. It should be an objective of these investments to realise the benefits within five years. The promoters of a venture should have the first option to purchase shares in their firm which became available in this way. The Council also welcomes the announcement that the National Development Corporation will be given the power to invest selectively in Irish companies that have a real prospect of becoming structurally strong.<sup>4</sup>

5.23 There is, in the area of some small businesses likely to be a strong case for State involvement. For a private financial institution the costs of accurately appraising loan applications from new businesses will often be prohibitive in comparison with those associated with extending credit to large and existing clients. The State through its many agencies involved in assistance to small business has often incurred, for other reasons, the costs necessary to accumulate information on small businesses. Therefore, the additional cost of appraising financing needs would often be marginal.

<sup>4</sup>In announcing the proposed role for the NDC, the Minister for Industry, Trade, Commerce and Tourism said that it would invest in companies which could become "structurally strong in the way that Telesis (NESC Report No. 64) envisages".

## APPENDIX A

### Terms of Reference

"To examine the role of the financial system in financing the traded sectors. To study the financing needs of traded sector businesses and the ways these needs are met. To make recommendations on ways the banks, insurance companies, pension funds and other financial institutions could make a greater contribution to development of these businesses."

### Issues to be Addressed

#### The Needs of Industry

- (1) What are the financing needs of traded sector businesses? How do the needs change at different stages of product/company development? in different markets and in different economic situations?
- (2) How are these businesses financed at present? equity, State incentives, own resources and, borrowings under what types of conditions?

#### Policy of Financial Institutions

- (3) To what extent do banks and other financial institutions lend to these businesses? What objectives and evaluation criteria are used by the institutions? Have they developed policies geared to the particular needs of the Irish economy? To what extent are policy decisions of the financial institutions influenced by the best interests of the economy? What is the significance of the growth in the importance of pension funds, insurance companies, etc., to the flow of funds for investment? What role should the Stock Exchange play?

#### Policy Options

- (4) What gaps exist between the needs of businesses and the existing financing arrangements? What might be the contribution of venture capital?
- (5) What can be learned from the experience of other countries in terms of
  - the contribution to industrial development by financial institutions?

- the advantages in financing arrangements available to firms located in other countries in comparison with firms located in Ireland.
- (6) What are the constraints to a greater involvement of the financial institutions in industrial development? Do Irish financial institutions have the expertise and experience to focus more directly on the needs of industry?
- (7) What criteria should guide the form of State finance to industry? (The evaluation of criteria should include consideration of the effect of State incentives on the relative attractiveness of traded and non-traded businesses.) To what extent should it be through grants, loans or purchase of equity? What types of funding are appropriate to the private sector?
- (8) What changes in public policies would encourage a greater contribution by the financial institutions to the development of the traded sectors? (The analysis should consider the extent to which there is real competition between the financial institutions.)

## APPENDIX B

### COMPOSITION OF STEERING GROUP FOR STAGE 1

Mr Liam Connellan, Chairman  
Director General,  
Confederation of Irish Industry

Dr Padraig McGowan  
Assistant General Manager  
Central Bank

Mr Frank Close  
Vice-Chairman, Irish Association of Pension Funds  
Secretary, A. Guinness, Son & Company (Dublin)

Mr Sean Fitzgerald  
Assistant Secretary, Policy and Planning Division  
Department of Industry and Energy

Mr John Walsh  
International Trade Division  
Department of Trade, Commerce and Tourism

Mr Martin Lowry  
Manager  
Planning and Accounts Division  
Industrial Development Authority

Mr Pat O'Reilly  
Assistant General Manager  
Industrial Credit Company

Mr R. Ian Morrison  
Deputy Governor  
Bank of Ireland

Professor Noel Mulcahy  
Member of the National Economic and Social Council  
Dean of Engineering and Science, NIHE, Limerick

Mr Paul Turpin  
Secretary to the NESC was Secretary to the group.

## APPENDIX C

### EQUITY INVESTMENT SCHEMES IN OTHER COUNTRIES

Tax incentives have been introduced in a number of European countries with a view to improving the equity base of industry and encouraging personal investor commitments in industry. The French Loi Monory introduced in 1978 provided an allowance against taxable income for net new investments in the shares of French companies. This scheme ran to 1982. A new scheme allows individuals to deduct from their tax liability 25% of their net new share purchases up to FF7,000 per year. A similar type of scheme operates in Belgium. In Sweden, individuals can now deduct from their tax liability 20% (30% in 1981 and 1982) of the cost of net new purchases in equity funds. A general improvement in the equity base of companies took place in these three countries after the incentives were introduced. It has been noted, however, that the measures coincided with the introduction of other measures to improve corporate profitability.<sup>1</sup>

In the United Kingdom the Business Start-up Scheme (BSS) was introduced in 1981 to encourage the purchase of shares not listed on the Stock Exchange. The scheme allowed a tax write-off of up to £10,000 (later raised to £20,000) in respect of investments in new manufacturing and service companies. "New" was defined as any trade which had not been in existence for more than five years. Critics of the BSS have said it failed through a combination of its restriction to new (higher risk) investments, the relatively low limit of relief and the complex legislative provisions.<sup>2</sup>

The Business Expansion Scheme (BES) replaced the start-up scheme in 1983. The BES has attracted a much larger flow of funds. The scheme allows: tax relief of £40,000 sterling at their highest tax rate for a married couple; the investment must be held for at least five years; the scheme is not confined to start-ups and most established trading companies qualify. As well as allowing direct investment by individuals,

<sup>1</sup>White, S., 1983. "European 'Monory Laws' ". *Focus on World Finance*, Phillips and Drew.

<sup>2</sup>Armitage, B., 1984, "The Business Expansion Scheme in the UK". *Investors in Industry*.

the Revenue Commissioners approve investment funds through which eligible funds under the scheme can be channelled. The complexity of the scheme rules has been seen as resulting in a dominance by fund investments and a bias towards safer investments in established companies.<sup>3</sup> It has also been argued, however, that the value of the tax advantage offered by the scheme means that the soundness of the underlying investment is a minor consideration: "the rate of return becomes practically immaterial provided that the company does not fail altogether."<sup>4</sup>

There has also been criticism of the BES on the grounds that it provides tax concessions on investments which are relatively risk free and do not make any additional contribution to economic growth. The announcement in the 1984 Budget that the purchase of farming land would no longer qualify under the BES scheme appears to have been in recognition of the validity of this criticism.

It must also be noted that in most other countries the State provides a relatively lower level of grant aid and tax concessions than in Ireland.

<sup>3</sup>Ibid.

<sup>4</sup>Hills, J., "Savings and Fiscal Privilege", *Institute of Fiscal Studies*, 1984.

## APPENDIX D

### RESERVATION BY ICTU REPRESENTATIVES (TO VENTURE CAPITAL INCENTIVE)

"Congress representatives have grave reservations about this proposal. A tax concession for risk capital, additional to the existing generous grants and corporation tax reliefs, will narrow the tax base and add an extra cost to the Exchequer which can only be made up by additional taxation elsewhere. The proposed relief means that the State will provide the investor with up to two-thirds of the amount of his or her investment.

This proposal is not necessary. Recent reports on industrial policy show that lack of finance is not a major constraint to industrial development. What is lacking is not capital but investment ideas and firms with the scale of operation and the technological, marketing and managerial capabilities to compete on international markets.

In any case, there already exist venture capital funds available for subscription which could, if necessary, be extended to cater for small investors. There is no evidence that it is lack of capital rather than ventures that is inhibiting the development of these funds. It would be absurd that the State should take on two-thirds of the risk where ventures fail and not benefit at all where the ventures succeed. Unless total failure of all such ventures is assumed, it would be cheaper for the State itself to provide the venture capital on an equity basis. There is no reason why, for example, the National Enterprise Agency should not be used for such investment."

## PART II

### THE ROLE OF THE FINANCIAL SYSTEM IN FINANCING THE TRADED SECTORS

by

F. Roche  
P. Dowling  
M. Walsh  
A. Hourihan  
J. Murray

## CHAPTER 1

### INTRODUCTION, SUMMARY AND CONCLUSIONS

This study is being completed at a time when Irish industry is in severe recession and Government is making strenuous efforts to control public spending. It is also a time when the US economy is in a high growth phase after a number of years of recession and when the OECD are predicting some upturn in the world economy.

A subcommittee was appointed by the National Economic and Social Council (NESC) to advise and monitor this study. The first meeting of the subcommittee took place on June 9th, 1983, at which time the programme for undertaking the study was agreed. We met the subcommittee during July and August. The fieldwork and data collection for the study were carried out during this period. The report and recommendations of the study were presented to the subcommittee on September 21st, 1983 and were accepted by the subcommittee. The report was subsequently reviewed and clarifications added after consideration of the comments, and our discussions with, the Economic Policy Committee of the NESC.

In this first Chapter of the report we begin by outlining the objectives of the study. This is followed by the identification of some guiding precepts which underpin the study and our approach to the task of completing the research. The chapter also contains a summary of our conclusions and recommendations.

#### 1.1 Objectives of the Study

The objectives of the study were clearly defined in the Terms of Reference provided by the NESC and are reproduced in Appendix 1. The objectives may be summarised as follows:

- To study the financing needs of traded sector businesses;<sup>1</sup>
- To examine how financing needs are being met at present;

<sup>1</sup>The study followed on from the Council's own review of industrial policies which emphasised the key role of traded sector firms in the growth of Irish industry. The recommendations in this report are designed to complement the strategy outlined for State-aid in NESC Report No. 66.

- To determine to what degree lack of finance is a major constraint;
- To recommend how the Financial Institutions could make a greater contribution to the development of traded sector businesses.

Our report and recommendations deal exclusively with the traded sector businesses as defined by the NESF (and reproduced on page 1). The report does not cover distribution, construction, or other non-traded sectors.

### 1.2 Guiding Precepts

There were a number of basic precepts which underpinned our approach to the study and guided our discussions. These may be summarised as follows:

- (1) Our primary aim has been to find constructive recommendations which are implementable.
- (2) We believe that if the proper environment is created in which Irish manufacturing industry is profitable it will then attract investment and the logical consequence will be an increase in employment and per capita income. By creating a proper environment we mean an environment which encourages and rewards enterprise and which involves greater numbers of people participating as promoters and beneficiaries in the enhanced profitability of Irish industry.

Given the current state of the economy and the strenuous efforts being made by Government to reduce spending we have purposely set out to ensure that our recommendations minimise demands on the Exchequer. In line with this we were anxious to avoid the creation of new Agencies, particularly at the State level.

In making recommendations, we were also conscious of the need to allocate clear responsibility for the implementation of the recommendations.

Finally, while our report deals exclusively with the traded sector firms in manufacturing and services we are of the opinion that the creation of an environment supportive of industry should not ignore the needs of the non-traded manufacturing, services and distribution sectors and the desirability of creating an environment which fosters enterprise in those sectors also.

### 1.3 Approach

In undertaking the study we began by seeking to construct a picture of the present financial state of Irish owned manufacturing industry. We also wished to see whether the financial structure of industry had changed over recent years. To carry out this phase of the study financial information was compiled on a sample of approximately 600 non semi-State, Irish owned manufacturing companies. Foreign controlled companies operating in Ireland were excluded from the sample because the financial status of these companies is primarily governed by the strength of the parent company.

To complete our research we conducted 107 interviews with representatives of institutions providing finance or services to the traded sectors. These included the Associated Banks, the Merchant Banks, the ICC, the Central Bank, the IDA, CTT, Pension Funds, Rescue Agencies, Government Departments, Stockbrokers, the CII, Venture Capitalists and Insurance companies.

We also developed an extensive questionnaire which was used as a guide in conducting 50 in-depth interviews with the Chief Executives/Financial Directors of a wide range of service and manufacturing companies. These companies ranged from the very large to small, from active exporting to those not exporting but with potential to do so.

### 1.4 Structure of the Report

The report is divided into seven chapters. The first part — this introductory section — also includes a summary of our conclusions and recommendations.

Chapter two is the start of the main body of the report and examines the current financial position of Irish industry. This is followed in Chapter three by an examination of the financing needs of Irish industry by the type of finance required. Chapter four considers the financing needs of firms at different stages in their life cycle — from the new venture stage through to the large-scale business. Chapter five analyses the different sources of finance, including a review of the availability of equity, long-term debt and short-term finance. Chapter six examines the financial expertise in firms and the relationship between firms and the suppliers of finance. The final Chapter — seven — details our recommendations based on the analysis presented in Chapters two to six.

### 1.5 Conclusions and Recommendations

#### *Conclusions*

Manufacturing industry in Ireland is divided into two distinct groups:

foreign owned manufacturing industry and Irish owned manufacturing companies. There are 5,245 Irish owned manufacturing companies employing 147,000 people. Foreign owned companies number 806 and have 92,000 employees. Foreign owned companies on average earn a very satisfactory level of profits, account for 70% of total manufacturing exports, and have few financing problems. Indigenous manufacturing companies, in contrast, have inadequate profits, suffer from a lack of equity, and do have financing problems.

The profitability of indigenous manufacturing industry has deteriorated significantly since 1978: in 1982 profits measured as a percentage of sales had fallen to less than 30% of the 1978 level. The fall in profitability has been accompanied by a 13% increase in the ratio of bank borrowings relative to equity since 1978.

The deterioration in profitability suggests a high degree of commercial risk in Irish manufacturing industry. This risk is further compounded by the small size of the average company, (only 105 indigenous companies employ more than 200 people, while 95% of companies have fewer than 100 employees), the smallness of the Irish market place and the consequent need to develop export markets in order to grow. In this situation high levels of borrowing add a degree of financial instability which further increases the risk profile of manufacturing industry.

(NB) There is a need to increase the level of equity in Irish manufacturing industry in order to reduce the risk profile, to provide a cushion in times of recession and a better base for expansion when the Irish economy recovers. Manufacturing industry has had difficulty in attracting equity funds due to its low level of profitability and the high returns which could be earned on alternative low risk investments. These higher returns largely result from tax biases which cause funds to flow into Government Gilts, Property and Insurance-linked Unit Funds.

The lack of equity finance does not mean that industry has been short of capital. Investment in manufacturing industry has increased at a much higher rate in Ireland than in other EEC countries over the last decade. The State has been a very significant supporter of companies in manufacturing industry through both grants, which are quasi-equity, and taxation policies. This has partially offset the lack of owner's equity. In the absence of equity funds it is not surprising that the banks have been significant lenders to manufacturing industry. Bank lending to the manufacturing sector increased by 22.5% p.a. between 1972 and 1982. Adjusting for inflation, bank borrowings increased by ... while the volume of production increased

by only 3.5%. The growth of industry borrowings at a rate well in excess of output has resulted in higher financial risk to the detriment of both borrower and lender.

The present high levels of real bank interest rates coupled with the low level of profitability in manufacturing industry makes it all the more inappropriate for industry to overly rely on bank debt for its funding. Serious problems now exist for indigenous manufacturing industry due to both the lack of new equity investment and the lack of profits. This is reflected in a reluctance on the part of banks to increase their lending to indigenous, non semi-State manufacturing industry.

Long term non-bank finance is not available at fixed interest rates which are acceptable to borrowers and which would, at the same time, provide an adequate return to Pension Funds and Insurance Companies. The long term debenture and loan stock markets have been dormant for several years and companies have had to rely on short and medium term loans from banks to fund expansion.

The deterioration in profitability and in the financial structure of indigenous manufacturing industry has been more significant in the larger companies. On average, large firms were trading at a loss in 1982 and had debt/equity ratios which were 60% higher than in small firms. This may reflect the fact that larger Irish companies are more likely to be in less profitable mature industries. Paradoxically, larger firms in general find it easier to obtain loans from banks than small companies and this is reflected in a higher level of borrowing.

Relative to large firms small firms are in a stronger position: their financial structure has not deteriorated since 1978 and while their profits have reduced since 1978 the reduction is substantially less than for larger companies. At the same time, however, the returns earned by small firms cannot be considered adequate as they are significantly less than the cost of capital to these firms.

It is tempting to deduce that the future of indigenous manufacturing industry lies in the small firm. This is not correct. The vast bulk of small firms will remain small. It is estimated that because of their small size and low technology base only 5% of small firms have the potential for significant export growth. Since 5% probably represents less than 300 companies it is important that these be identified and that every effort is made to expand their export potential.

It must be emphasised that the larger companies, those 282 Irish owned



companies who employ more than 100 people, account for 46% of employment in indigenous manufacturing industry. These larger companies are of vital importance to Ireland's manufacturing base, yet it is this group which has the highest level of borrowings and lowest level of profitability.

Indigenous manufacturing industry has an inadequate equity base which limits its ability to grow and, in particular, limits its investment in export marketing. A proper environment must be created which will be conducive to risk taking and which will cause equity monies to flow into all stages of manufacturing, from the new ventures to the larger more developed company. There is a need to foster risk taking in new ventures since these will be the growth companies in the years to come. For the foreseeable future, however, the major employment base in manufacturing industry will be the group of companies which already exist and the financial strength of these companies must be improved.

Finally, it must be recognized that while it is essential to provide a stimulus to generate a flow of equity into manufacturing industry this inflow will only be sustained if adequate levels of profitability are achieved. In recent years indigenous industry has not been sufficiently profitable and in the absence of grant aid it is likely that very little investment would have taken place.

#### *Recommendations*

The recommendations in this report are detailed in Chapter seven. The key recommendations are briefly summarised below and are followed by the further recommendations presented in point form.

#### *Key Recommendations*

1. REMOVE THE DISTORTIONS IN THE RISK/REWARD TRADE-OFF SO AS TO ENCOURAGE EQUITY INVESTMENT IN MANUFACTURING

*Bad washing*  
The returns which can be earned from risk free investments including Government Gilts is so high that manufacturing industry finds difficulty in attracting equity capital. The tax advantages which low risk investments in Gilts and single premium insurance funds enjoy should be removed.

2. PROVIDE POSITIVE BIAS TOWARDS INVESTMENT IN SEED, VENTURE AND DEVELOPMENT CAPITAL

*Finance at*  
To encourage the flow of equity capital into industry tax write-offs should be available for investors who provide equity capital to traded sector companies. The maximum amount of investment which would

be allowable for write-off would be £5,000 p.a. per investor. The degree of tax write-off should decline from 100% in the case of seed capital to 75% for new venture enterprises, to 50% for investment in other traded sector companies. The allowance should be available for investment in new equity or rights issues for any traded sector company including companies quoted on the Dublin Stock Exchange provided the net asset value is less than £10 million.

3. BANKS SHOULD TAKE EQUITY IN ENTERPRISE DEVELOPMENT PROGRAMME (EDP) COMPANIES

The Enterprise Development Programme is the IDA's programme for encouraging executives to establish new ventures in high growth, high technology sectors. These companies suffer from a severe lack of equity and an excessive level of bank borrowings. This position could be reversed if the banks were to provide support by taking equity participations in these companies. Many of the existing bank loans to these companies have the risk characteristics of equity, but the lower payoffs associated with debt finance.

4. LINK IDA GRANTS TO COMPANY PERFORMANCE AND HAVE AN EQUITY MATCHING REQUIREMENT

Establish a system whereby companies would only expect a favourable response to second round grant applications in situations where the company has achieved objectives previously agreed with the IDA. Where exports are involved it is appropriate that CTT be involved in reviewing export marketing plans and objectives. Companies should also be required to match second and subsequent rounds of grant aid with an equal amount of equity in the form of cash investment or realisable retained earnings.

5. ENCOURAGE BANKS TO DEVELOP A MUCH WIDER SECTORAL EXPERTISE THAN THEY HAVE AT PRESENT

By developing greater expertise banks could better meet the needs of their client base and reduce the dependence on security-oriented lending. Bank lending risk will be reduced and there will be increased flexibility for borrowers.

6. PROMOTE COMPETITION IN THE BANKING SYSTEM BY DISMANTLING THE "BANK CARTEL"

Increased competition between the Associated Banks will result in a higher level of service and increased innovation and creativity in the commercial banking system. At present there is no perceived difference between the Associated Banks, all of whom offer essentially the same

level of service and react in unison to changes in customer needs. Manufacturing industry would benefit from this increased competition between banks.

**7. MAKE THE CENTRAL BANK RESPONSIBLE FOR REGULATION OF ALL FINANCIAL INTERMEDIARIES**

Consistent with the view that competition between financial institutions be maximised and that distortions in the risk/reward ratio be reduced, we suggest that all deposit taking institutions be regulated by one authority, namely the Central Bank.

**8. ALL FUNDS FOR COMPANIES BEING RESCUED AND RECEIVING REFINANCING PACKAGES SHOULD BE CHANNLED THROUGH FOIR TEORANTA WHICH SHOULD BE THE PRIMARY STATE RESCUE VEHICLE**

State funds for rescue should be sourced from a single agency with the objective of saving only those companies with real development potential. Foir Teo should play the lead in all cases except where takeovers are involved. The IDA has an important advisory role to play in all cases and a key role in takeovers where Foir Teo funds should not normally be required. Where Foir decides to rescue a company it should have power to take over the Revenue debts, in return for a significant equity stake in the company.

**9. ESTABLISH A MORE AUTONOMOUS IRISH STOCK EXCHANGE**

An Irish Stock Exchange Council representing all spheres of investor interest should be set up to oversee the operations of the Irish Stock Exchange. As a source of capital for Irish industry the Stock Exchange can only be improved by developing a market which recognises the special needs of the Irish economy whose state of development is altogether different to that of the UK economy.

***Further Recommendations***

**1. CAPITAL GAINS TAX SHOULD BE APPLIED ONLY TO GAINS WHICH ARE REALISED FOR CONSUMPTION PURPOSES AND NOT ON GAINS WHICH ARE RE-INVESTED.**

**2. CO-OPERATIVES TO RAISE EQUITY VIA ROYALTY-TYPE BONDS.**

**3. BANK LOAN REFUSALS SHOULD BE ACCOMPANIED BY**

- (a) REASONS WHY THE LOAN WAS TURNED DOWN, and
- (b) SUGGESTIONS AS TO WHAT ACTION SHOULD BE TAKEN BY THE COMPANY TO MAKE THE PROPOSITION BANKABLE.

**4. REMOVE THE ANOMALIES WHICH EXIST IN THE APPLICATION OF VAT AT POINT OF ENTRY.**

**5. PROVIDE SOME RELAXATION IN EXCHANGE CONTROL REGULATIONS AS THEY APPLY TO FOREIGN TRADE.**

**6. PENSION FUND HOLDERS SHOULD BE ENCOURAGED TO IDENTIFY MORE CLOSELY WITH THEIR PENSION FUND INVESTMENTS BY BEING FULLY INFORMED AS TO HOW FUNDS ARE INVESTED.**

**7. CENTRALISE RESPONSIBILITY FOR EXPORT CREDIT INSURANCE WITH THE DEPARTMENT OF INDUSTRY, TRADE, COMMERCE AND TOURISM.**

## CHAPTER 2

### THE CURRENT FINANCING OF INDIGENOUS MANUFACTURING INDUSTRY

#### 2.1 Current Financing and Trends

A major constraint in undertaking this study was the absence of either profit and loss or balance sheet data both for manufacturing industry in aggregate and for manufacturing industry on a sectoral basis.

To overcome this problem, Allied Irish Banks, Bank of Ireland and the Industrial Credit Company each agreed to select a sample of 200 indigenous, non semi-State companies. The sample from each bank included financial data on 20 companies in each of 10 manufacturing sectors. The 20 companies were further subdivided by loan size into two categories. In each sector 10 companies were chosen with loans in excess of £250,000 and 10 companies with loans of between £50,000-£250,000. In measuring the loan amount account was taken of all bank lending to the company, and not just the loans from the institution supplying the data.

In theory, the total sample size may be as high as 600 companies; in practice this is most unlikely. While each bank randomly selected 200 companies it is highly probable, given the existence of multi-bank relationships that some overlap occurred. This is particularly likely in relation to those companies with large borrowings, where multi-bank relationships frequently occur. Given the nature of the ICC, which does not provide current accounts, it is probable that ICC clients would have a banking relationship with other institutions as well.

The data was compiled for the balance sheet years ending on the dates closest to December 31st in each of the years 1978 and 1982. Some further bias exists in the data because the sample was restricted to those companies actually in existence at the end of 1982. Consequently the trends depicted in the data understate the deterioration in Irish manufacturing industry over the five-year period by excluding those companies which have disappeared in the period.

On a statistical basis the sample is sufficiently large to give an accurate

representation of the financial state of Irish manufacturing industry. Tables 1 and 2 show the Balance Sheet, Profit and Loss and Ratio Analysis for all Irish owned manufacturing industry. (All references in this report to the financial data refer only to indigenous non semi-State manufacturing industry unless specifically stated otherwise.)

Table 1

Balance sheet and profit and loss statistics for all manufacturing industry 1978 and 1982

	1978 %	1982 %
<b>Balance Sheet</b>		
<i>Current Assets</i>		
Stock	24	25
Debtors	32	30
Cash, Bank Balances	4	4
Other	4	2
<b>Total Current Assets</b>	<b>64</b>	<b>61</b>
<i>Fixed Assets</i>		
Land, Buildings	23	26
Plant, Equipment, Motor Vehicles	13	13
<b>Total Fixed, Other Assets</b>	<b>36</b>	<b>39</b>
<b>Total Assets</b>	<b>100</b>	<b>100</b>
<i>Current Liabilities</i>		
Creditors	28	29
Current Borrowings	10	10
Other	8	6
<b>Total Current Liabilities</b>	<b>46</b>	<b>45</b>
Issued Capital	13	13
Capital/Rev. Reserves	25	24
Government Grant	3	3
Term Borrowing	10	12
Other	3	3
	54	55
<b>Total Liabilities</b>	<b>100</b>	<b>100</b>
<b>Profit and Loss Account</b>		
Sales/Assets	157	147
Gross Profit/Sales	17	15
Interest/Sales	2	2
Depreciation/Sales	2	2
<b>Net Profit Before Tax/Sales</b>	<b>5</b>	<b>2</b>

Table 2

## Selected financial ratios for all manufacturing industry 1978-1982

Ratio	1978 %	1982 %
PBT/Sales	5.4	1.6
Interest/PBIT	23.4	59.3
Total Borrowings/Net Worth	51.7	58.6
Current Assets/Current Liabilities	139.0	135.0
Debtors/Sales	20.6	20.5
Stocks/Sales	15.5	16.6
Creditors/Sales	18.0	19.5
Land and Buildings/Fixed Assets	64.5	66.9
Fixed Assets/Total Assets	35.6	38.5
Short Term Debt/Long Term Debt	105.0	85.2
PBTD/Total Debt	60.0	25.0
Working Capital/Total Assets	18.0	16.0

*Where:*

PBIT = Net Profit Before Interest and Tax  
 PBTD = Net Profit Before Tax and Depreciation  
 PBT = Net Profit Before Tax

*Commentary on the Balance Sheet and Profit and Loss Accounts*

The Balance Sheet and Profit and Loss Accounts in Tables 1 and 2 are calculated by arithmetically averaging across all sectors and across both loan classifications, providing equal weighting to all sectors and each loan size classification.

- Profit margins [net profit before tax relative to sales] have decreased substantially and in 1982 were down to a level of only one third the 1978 margins.
- Interest as a percentage of profit before interest and tax has increased by 150%.
- Bank borrowing to net worth has increased by 13%. This is almost entirely due to increases in term borrowing which was 20% higher in 1982 than in 1978.
- The ratio of cash (i.e. net profit before tax plus depreciation) to bank debt has declined almost 60% indicating a very substantial increase in financial risk and reduced availability of cash to repay bank debt.
- Fixed assets relative to total assets increased by about 10% during the period. This was almost entirely due to the increased investment in land and buildings.

There was a decline from 18% to 16% in the proportion of working capital to total assets. Individual elements of working capital showed very little change.

A marginal decline [2.6%] in the proportion of shareholders' funds (i.e. issued capital plus capital and revenue reserves) to total liabilities also occurred.

Other items of particular interest which emerge are:

- IDA grants are approximately 8% of shareholders' funds. This, however, greatly understates the importance of grants in the financing of new investment. In 1982 the IDA approved grant assistance of £240 million against investment commitments by firms of over £580 million.
- Land and Buildings are 26% of Total Assets.
- Deterioration in profit margins has been much less for the smaller firms and indeed in some sectors margins have improved since 1978. The Wilson Report in the UK also found that on average smaller firms were more profitable than large companies. However, while small companies in our sample were, on average, more profitable the profit level was still inadequate in relation to the cost of funds and the levels achieved by industry in other countries.
- Security in the form of mortgages was provided to the lending banks by over 90% of borrowers.
- The ICC would appear to be lending to more highly geared companies than the Bank of Ireland and Allied Irish Banks.
- Companies borrowing from the ICC have a significantly higher percentage of term debt than those borrowing from the AIB or BOI companies.

In examining firms broken down by the size classification some additional differences emerge:

Profit levels are inadequate in both small and large companies. However, on a relative basis the small companies are more profitable and better structured. Profit margins, as measured by net profits before tax relative to sales have fallen in both size classifications. The margin has fallen from 5% to nil in the large companies, and halved from 6% to 3% in the small companies.

The cash flow coverage of debt [measured by net profit before depreciation and taxes to debt] has declined from 50% to 14% in the large companies and from 73% to 38% in the small companies. Gearing has also increased substantially in the large companies, from 59% to 73% of net worth, whereas for the small companies at 47% the ratio has not changed significantly.

### Growth in Bank Lending

During the period 1972-1982 loans by all licenced banks to manufacturing industry increased by £1,040 million (Appendix 28). Over the period the Associated Banks maintained their share of this lending at approximately 50%. However, there was a significant shift in the proportion of funding provided by sources other than the Associated Banks. The importance of the Merchant Banks more than doubled during the period while the North American banks' share of loans to manufacturing fell by more than half to 15% (Appendix 29).

Total bank lending to manufacturing increased at a compound rate of 22.5% p.a. between 1972 and 1982 (if these figures are adjusted for an estimated amount of lending in the form of leasing, instalment credit etc., the percentage increase is 20.8% p.a.). Over the same period inflation (as measured by the Consumer Price Index) increased by an average of 15.4% compound p.a. using wholesale prices the percentage increase was 15.5% p.a. In other words, bank borrowing by manufacturing industry increased in real terms by 6.0% p.a. Over the same period the volume of production in manufacturing industry increased by only 3.5% p.a. In the period 1978-1982, the same period as our sectoral data, the volume increase was only 1.9% p.a. while the increase in bank borrowing was in excess of 28.6% p.a. (adjusted from leasing etc., the estimated increase was 16% p.a.). Over the same period wholesale prices for manufacturing industry increased by 12.6% p.a. (consumer prices by 17.1% p.a.).

Some points which emerge from data on lending to industry are:

- The banks have been very significant lenders to manufacturing industry over the last decade.
- Industry borrowing grew at rates well in excess of the growth in output, resulting in industry having a much higher risk profile to the detriment of both borrower and lender.

There would now appear to be a reluctance on the part of banks to increase their lending to indigenous, non semi-State manufacturing industry. This is in part due to the growth in lending referred to above, in part due to the lack of profitability in industry and in part due to the Bank Levy which is a tax on the Banks equity. The effect of the Bank Levy is to reduce the risk-taking capacity of Banks through a reduction in their equity base. During a recession when demand for loans from industry is low this reduction in lending capacity may not be important; it could however, be a constraint when the demands from industry increase with economic recovery. Any limitation of the Banks risk-taking capacity is bad for manufacturing industry.

### 2.2 Comparison with Other Countries

While it is relatively easy to generate data for a number of different countries, the data must always be treated with the greatest care. Accounting practice and tradition weigh heavily in both the compilation and interpretation of accounts. A ratio which may be considered appropriate in Germany may be totally unacceptable in Ireland.

This is especially the case in Japan-where the average level of shareholders funds to total assets is only 21%.<sup>1</sup> Japanese companies can deduct from their computation of retained earnings a wide range of tax-free reserves, for special purposes, e.g. small and medium sized companies are allowed to provide a reserve for overseas markets development. These reserves normally appear as long term liabilities on the balance sheet, rather than as part of the shareholders funds. Debtors balances also tend to be high in Japan, as larger companies provide trade finance for smaller companies. Japanese companies do not use inflation adjusted accounts and an unofficial estimate for 1975 suggests that the ratio of equity to total assets was between 40% and 50%.<sup>2</sup> The official ratio for that year was only 14%. This suggests that true equity ratios are at levels not dissimilar to those in other developed countries. While historically Japanese gearing ratios have been high they are declining. In 1970 long term debt accounted for 31% of the financing of total assets. This had declined to 22% by 1981. Toyota, which no longer has any debt is a quoted success story.<sup>3</sup>

Due to the structural similarity between Irish and UK industry, and because of the similar accounting practices we will initially compare the financial structures of industry in the UK and in Ireland. Even in comparison with the UK there are problems because the sectoral classifications do not match exactly and due to the larger scale of UK based industry. In 1975 the Wilson committee compiled information on 300 of the smaller companies in the UK. These companies were defined as having capital employed of less than £4 million (equivalent to £10.9 million at the end of 1982).

Some key points which emerge from comparing the Irish data with data for other countries:

<sup>1</sup> The Financial Structure of Japanese Companies by Bunji Kure, Management - Corporate Finance, 1982.

<sup>2</sup> Japanese Corporate Finance 1977-80. A Business study by International Business Information Inc. Published by The Financial Times Ltd., 1977.

<sup>3</sup> The Financing of Japanese Industry by C.D. Elston, Bank of England Quarterly, December 1981

(1) The level of utilisation of assets, measured by the ratio of sales to total assets, is very similar in both the UK and Ireland at about 1.46.

(2) Irish firms have relatively high amounts of investment in fixed assets, relative to their UK counterparts. For the period 1981/82 fixed assets amounted to 32% of total assets in the UK, whereas the ratio for Ireland is 39%. The financial data provided on small firms in the UK by the Wilson Report indicates that the ratio of fixed assets to total assets was 24% higher for Irish companies than for small companies in the UK. The high level of fixed asset investment in Irish manufacturing industry, relative to their UK counterparts, may partially reflect the imbalance between the factor costs of labour and capital as highlighted in McAleese.<sup>4</sup> While direct comparison with Germany is difficult because of differences in accounting treatment, a survey of six German sectors indicates a 4% higher level of fixed assets in Ireland than in Germany.

(3) Short term debt is used to a much greater extent in Ireland than in the UK. Relative to total capital employed short term debt in Ireland is one third more important in small Irish companies and 50% more important in the large, than in the UK companies. Compared with a similar ratio for the United States short term debt is used over three times as much in Ireland.

(4) The level of debt, relative to the equity base appears to be higher in Ireland than in either the UK or USA. The Wilson Report on small firms showed that in 1975 net bank funding, represented only 9% of total assets in the UK. In 1978 the comparable Irish figure was 16% and by 1983 had risen to 18%. The Wilson Report also found that 54% of the small firms in the UK had no borrowings.

(5) Equity relative to total assets is much lower in Ireland than in either the UK or the USA. Allowing for the adjustments to the Japanese data there is a much higher level of equity in Japanese companies than in Irish. In Ireland shareholders funds on average finance 37% of the total assets. In the UK shareholders funds contribute 44% of total asset financing, and in the USA shareholders funds account for 50% of the total finance.

It must also be emphasised that Irish industry, in general, is small

<sup>4</sup>"Is there a shortage of capital for industry" by D. McAleese. Jubilee lecture of the Industrial Credit Company.

industry and should therefore proportionately have a much higher equity base than in other countries where industry consists of larger firms, which, because of size, can survive set-backs. Small companies with an inadequate equity base have little chance of surviving even minor set-backs.

(6) On average Irish industry appears to be less profitable than UK industry. The large Irish companies on average made no profits. UK manufacturing companies make an average margin, measured by profit before tax to sales, of 3.7%. The six sector German statistics show profit levels similar to the UK.

#### *The Profitability of Manufacturing Industry*

While it is clear that profitability in indigenous manufacturing industry has deteriorated, this is not a problem that is unique to Ireland. The evidence available on corporate performance in the EEC suggests that on average Community industry has not performed as well as its US and Japanese competitors in the 1970s.

Part of the weakness lies in the relative inability of European industry to generate an operating surplus which can keep up with the rising cost of capital. As we have seen in the case of Ireland, interest as a percent of profit before interest and tax has increased significantly in recent years.

Analysis of EEC company accounts reveals a weaker performance in terms of sales margins, return on assets and return on equity by Community companies than by US and to a lesser extent Japanese companies. For example, in 1980 the first 100 industrial groups in Europe realised an average net profit on sales of 1.4% against 2.4% for the first 100 Japanese and 4.8% for the first 100 groups in the US. The net profit on sales for the top 25 Irish quoted companies (obviously a limited sample) was 4.0% in 1980 (see Appendix 27). The return on sales for all of the companies in our bank sample was 5% in 1978 and 2% in 1982. The Irish figures are calculated on a pre-tax basis but this does not significantly influence the results due to the low level of tax paid on manufacturing profits in Ireland.

In terms of net profit to capital employed the figure for the large European companies was 6.5% in 1980, 14% for the Japanese and 15.6% in the US. The 25 quoted Irish companies had a return of 6.6% in 1981. The return on equity based on our bank sample was 20.7% in 1978 and 7.9% in 1982. Again, our sample figures are calculated on a pre-tax basis.

Table 3 shows net profit on sales by country for 392 manufacturing companies over the period 1970-77.

**Table 3**  
Net profit on sales of 392 manufacturing enterprises<sup>1</sup>

	1970	1973	1977	Number of companies in 1977 sample
FR of Germany	2.44	1.95	1.77	31
France	4.49	2.59	1.83	23
Italy	4.45	0.33	-5.51	7
United Kingdom	4.37	6.21	3.91	40
The Netherlands	3.90	4.80	3.60	3
Belgium	3.97	3.58	0.32	3
Japan <sup>2</sup>	4.15	4.10	1.76	103
USA	4.87	5.93	4.77	182

Notes: <sup>1</sup>Net post-tax profit on gross sales of 392 major enterprises, including oil companies and major retailers.

<sup>2</sup>Japanese sample has a higher proportion of smaller enterprises.

Source: EEC Publications.

Table 4 below shows that while manufacturing investment in EEC countries has not been buoyant in recent years, Ireland has gone against this trend and has shown significant increases.

**Table 4**  
Manufacturing investment in the Community<sup>1</sup>  
(Volume index, 1975 = 100)

	1975 (1000m. ECU)	1970	1975	1976	1977	1978	1979	1980
FR of Germany	13.33	146	100	106	108	108	119	127
France	10.06	103	100	108	102	100	-	-
Italy	6.72	110	100	97	98	91	100	-
Netherlands <sup>2</sup>	2.20	113	100	90	104	108	105	-
Belgium	2.21	99	100	88	73	71	72	-
Luxembourg	0.13	117	100	80	106	-	-	-
UK	6.09	116	100	95	100	107	111	100
Ireland	0.38	74	100	99	102	136	-	-

Notes: <sup>1</sup>Denmark: Not available.

<sup>2</sup>The Netherlands: including energy and construction.

Source: EEC Publications.

### 2.3 Summary

The analysis and comparison of the financial position of Irish manufac-

turing industry in 1978 and 1982 revealed the following major trends:

- Profitability has deteriorated significantly.
- Cash flow coverage to debt and interest has deteriorated substantially.
- Debt to equity ratios have deteriorated over the period but not dramatically. It is possible, however, that revaluation of assets has helped to keep this ratio from deteriorating further.
- Banks took security in the form of mortgages and/or personal guarantees in 90% of loans advanced.
- Investment in land and buildings has increased over the period and represents 26% of total assets, or double the investment in productive plant and equipment.

The licensed banks have been significant supporters of manufacturing industry over the seventies. Bank lending increased by an average of 6% p.a. on a compound basis between 1972 and 1982 after allowing for inflation. Over the same period manufacturing volumes only increased by 3.5% p.a.

While it is relatively easy to obtain financial data for manufacturing industry overseas, comparison of foreign data must be interpreted with care. In Japan debt to equity levels appear high since fixed assets are significantly under-valued. Similarly, in Germany hidden reserves tend to under-value equity and result in debt/equity ratios appearing higher than they really are.

It is important to emphasise that due to the small size of Irish manufacturing firms direct comparison with other countries is difficult. In the UK Bank debt amounts to 9% of total assets in small companies; the figure for small companies in Ireland is 18%. In 1975, 54% of all small firms in Britain had no bank debt. Profitability levels in Ireland are approximately 1% lower than in the UK. The larger companies in the Irish sample made a loss in the period 1978-1982. There is evidence of high investment in fixed assets in Ireland relative to the UK. Fixed assets amount to 39% of total assets in Ireland compared to less than 32% in the UK.

The low level of profitability in Ireland suggests a high degree of commercial risk in Irish manufacturing industry. This risk is further compounded by the small size of the average company, the small size of the Irish market and the need to develop foreign markets in order to grow. In this situation high levels of borrowing relative to equity add a degree of financial instability which further increases the risk profile of manu-

facturing industry. There is a need to increase the levels of equity in Irish manufacturing industry in order to provide a better base for expansion and growth and with this growth increased levels of profitability.

## CHAPTER 3

### THE FINANCING NEEDS OF IRISH INDUSTRY

This chapter identifies the major problem in attracting equity type funds to industry as being the pro-Government, and pro-property biases introduced by the taxation system. In effect there are strong inducements away from direct equity investment in industry. This is followed by an examination of fixed asset, current asset, and export related financing. It is important to recognise that industry is only one of the competing demands for the limited amount of funds actually available for lending. The allocation of these funds will depend primarily on the potential returns and the associated risk of the alternative investment opportunities. Initially we will examine how this risk/reward relationship has evolved in Ireland over the past decade.

#### 3.1 The Risk/Reward Relationship for Alternative Investments in Ireland

Between 1970 and 1983 (see Appendix 39) the compound average nominal return for the pension fund, or zero rate tax payer was 11.4% on long gilts, 19% on property and 16% on Irish equities. The worst investment for the pension fund was short gilts which yielded 10.7% compound on average. Over the same period inflation averaged 14% p.a.

From a fund manager's point of view equities were much less attractive than property due not only to the lower returns but also due to the very substantial degree of fluctuation in their capital values, e.g. in 1974 equities lost half of their total market value.

The risk/reward trade-off is not unreasonable for the zero rate tax payer. The introduction of tax, however, completely distorts the trade-off. It is possible for any investor (note: provided he is not defined as a trader) to completely avoid all tax on returns from investments in Government stock. Consequently over the period 1970 to 1983 the after tax return for a 65% tax payer on Government gilt investments would have been about 11%.

Returns on both property investment and equity investment are in general subject to tax. Assuming a top rate tax payer of 65% over the



period the after tax return on equities would have been 11% and on property 17%. This contrast is even more extreme if one looks at the current yields available on gilts, 13.9% after tax, versus a current gross yield of 5.5% on equities and an 8% gross yield on prime office properties. Table 5 shows the post-tax returns available on the various investments. In compiling the property figures it has been assumed for illustration that all income from property was tax exempt due to the operation of interest relief and other allowances.

Table 5

Post-tax returns on investments  
(per cent per annum)

	1970/83		1978/83	
	Nil	65%	Nil	65%
Short Gilts	10.7	10.7	9.7	9.7
Long Gilts	11.4	11.4	11.3	11.3
Property	18.8	18.8	23.9	23.9
Equities	16.1	11.2	14.7	9.6
Inflation (CPI)	13.9		14.6	

Source: Compiled from data supplied by Goodbody and Wilkinson, Jones Lang Wootton, and Dudgeon & Co.

Other biases exist which have not been taken into account in this analysis. There are additional advantages to buying some Government gilts for the purpose of paying capital acquisitions tax. There are substantial biases in favour of both domestic and commercial property investment, including special depreciation allowances on industrial buildings, section 23 or section 29 relief on residential accommodation under a certain size and mortgage relief on personal dwellings and property investment. No such incentives exist for equity investment. Taking these biases into account the worst possible investment over the last decade for the high tax payer has been equities.

The investor is currently faced with a very strong dis-incentive to direct equity participation. By investing through the medium of insurance-linked Unit Funds the investor can restrict his effective tax payment to about 30%. A high tax payer would have to be fairly certain of achieving a return at least 30% higher than the professional managers can to have any incentive to invest directly.

The position of Building Societies is also a further anomaly as they enable people to be taxed at a level below the standard rate even if they are in the high tax brackets. Similar types of anomalies also exist

between the various deposit-taking institutions, i.e. the Trustee Savings Banks and the Post Office. All of these anomalies lead to distortions in the allocation of funds.

One other distortion exists and underlines the total pro-property and anti-equity bias for the private investor; it is the ability to offset mortgage interest against rental income. No offset is allowed to an individual who borrows to invest in equities except the limited extent allowed to those who invest in the companies where they are employed full time.

The distortions which have been addressed in this section are entirely of a fiscal nature. These fiscal policies have arisen on a piecemeal basis over the years without any cohesive policy available. This has reflected the strength of individual interests, rather than promoting the equality which would derive from a single supervisory body, which would ensure more constant application of policy.

This pragmatic solution of individual problems has led to a position where the investor in manufacturing industry has been discriminated against. There is a clear need to remove the distortions that exist between the different deposit-taking institutions. To help ensure that unnecessary distortions do not arise in the future all deposit-taking institutions should be supervised by a single regulatory authority.

### 3.2 Fixed Asset Financing

Fixed assets in a manufacturing company consist primarily of the company's land and buildings and the machinery, plant and equipment used in the manufacture and distribution of its products. On average, land and buildings in Irish manufacturing accounted for 67% of total fixed assets in 1982 compared with 65% in 1978. There is no difference in the ratio between large and small firms. Irish companies have over twice the amount of funds invested in buildings as they do in productive plant and equipment.

Our interviews indicated that few companies had difficulty in raising finance for the purchase of fixed assets. This is not surprising since the IDA provides between 25% and 60% of the cost of fixed assets, depending on location. This makes the provision of bank financing relatively easy since banks need only finance a portion of the fixed asset cost while receiving 100% security.

In the case of plant and equipment the actual market value in a liquidation will generally be considerably less than cost or book value. A bank expecting to be repaid from the sale of plant and equipment is

likely to be disappointed. Nevertheless, there appears to be little difficulty in financing these types of assets. It has been noted that it is the practice of the Associated Banks to direct customers to their finance company subsidiaries where interest rates are significantly higher. Where companies are large and sophisticated the borrower can generally negotiate favourable interest rates but this is not so for the smaller companies.

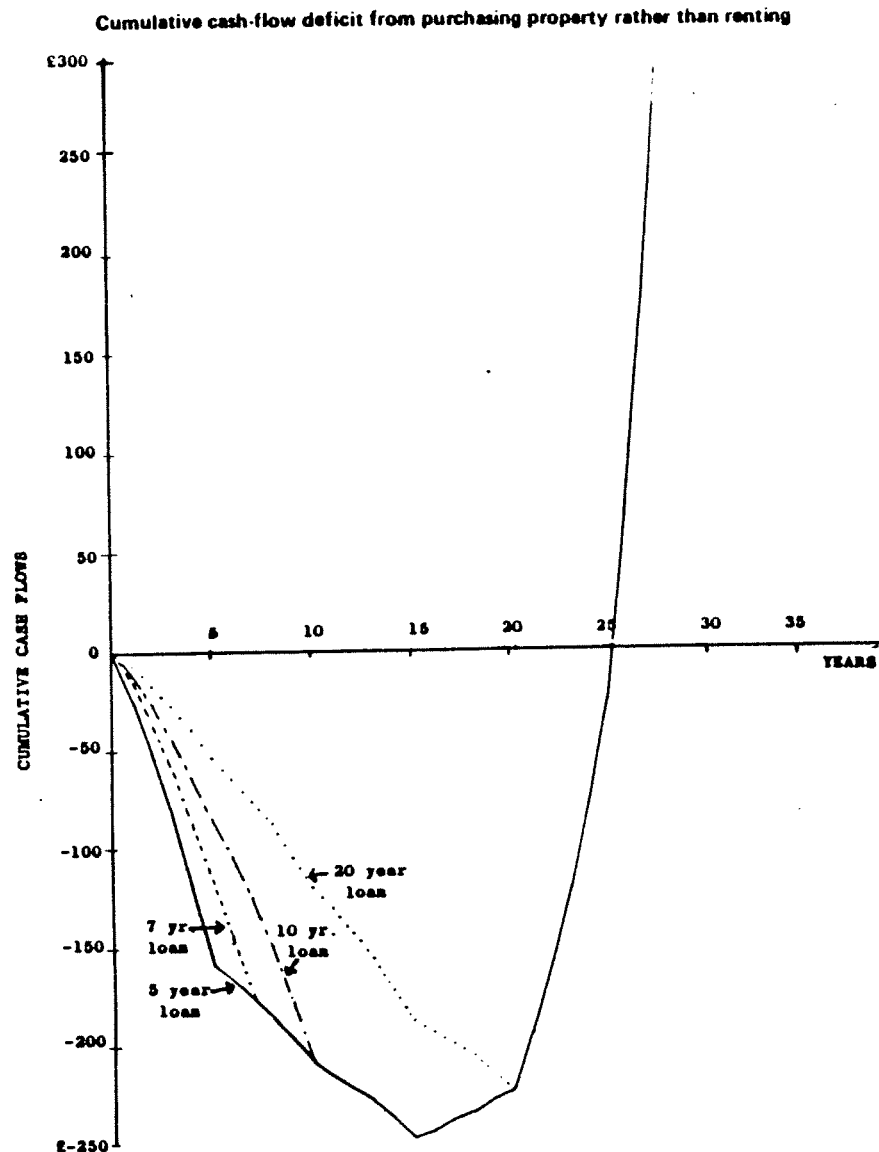
Extensive use has been made of tax-based leasing as a mechanism for financing plant and equipment. The importance of leasing can also be approximated by observing that 13% of all IDA grants went towards lease-type purchases. The annual amount of leasing to grant aided manufacturing industry is not available. However, the 1982 IDA Annual Report shows £19.1 million grants towards the leasing of fixed assets. Using the median grant rate of 35% this would indicate gross leasing commitments of about £55 million p.a. to such industry.

Quoted interest rates on tax-based lending have been very low and on occasion negative depending on the percentage grant and the amount of capital allowances available. These quoted low rates are very attractive to foreign industry and the IDA believe that they are an essential part of the incentive package for attracting foreign industry. Other countries provide interest subsidies and the UK provides leasing on similar terms to Ireland. However, as was pointed out in NESC Report No. 64, the benefits of tax-based leasing are concentrated almost exclusively in the large foreign-based industries and the allocation of such benefits should be calculated as part of the total package. In general the smaller indigenous manufacturing firms have not benefited from tax-based lending. The banks estimate that only 10% of the savings available from tax-based lending accrue to the small Irish companies.

Financing of land and buildings is typically provided by the banks via term loans repayable over 5-7 years (ICC up to 10 years). As with financing plant and equipment the existence of IDA grants allows for a margin of security for the banks. Clearly in good times this security provides a good cushion for the banks. However, in times of general recession banks may have difficulty in realising the value of their security. Banks do of course have the option of holding on to security and waiting for times to improve. On balance, however, the security of fixed assets results in their being relatively easy to finance.

Insurance companies and pension funds play little part in financing land and buildings. This is regrettable since land and buildings should be financed over much longer periods than the 5-7 years term periods

Figure 1



Note: Graph assumes 14% fixed term loans for either 5, 7, 10 or 20 years for purchasing. Renting assumes 35-year lease with 5-year rent reviews and a 10% rate of inflation. Initial rent of 8% p.a.

Example: Assuming initial asset value of £100, after 5 years the company is worse off relative to renting by:

£159	on a 5 year loan,
£115	" " 7 " "
£ 84	" " 10 " "
£ 54	" " 20 " "

In Figure 1 the cumulative cash flow effects on a company of buying its property with different period loans is contrasted with the effect of taking on a 35-year lease with five-year rent reviews. Assessing the value of the building as an asset independent of the business provides a strong bias in favour of property ownership. As an investment property ownership may be very sensible, but when considered as part of the business it may be irrational. Most businesses purchase property because they need a location in which to carry on their business. They will have this location irrespective of whether they own or rent the property. In valuing a business enterprise, property is only of value if the company is being broken up. In the absence of any intended liquidation of the business the value of the company is solely dependent on the cash it can generate. If one can only generate this cash by having a location in which to operate then the value of the property is irrelevant except, possibly, as security to lenders who are concerned only with their position in the event of company collapse.

As can be seen from Figure 1 the effective cash drain on a business from investing in property is very substantial in early years compared to a rental agreement. The exact time period to break-even will depend on both inflation and interest rates. Assuming constant inflation of 10% p.a. and constant interest rates of 14.0% p.a. the time period for break-even is 25 years. This assumes a 35-year lease with an 8% initial yield and five-year rent reviews over the full life of the lease. The lessee is better off in terms of cash outlay for the first 25 years of the lease than he would have been had he purchased the building on day one. (Increasing the initial yield to 10% would reduce the cash flow break-even period to 20 years.) The calculations assume that all surplus funds are reinvested at 14% (i.e. the borrowing rate and deposit rate are equal). Over the full 35-year period there is a saving from the purchase option, but because of the substantial additional cash drain in the first 25 years the business may not actually survive to avail of the surplus available after the 25th year. As the initial rent is increased closer to the 14% borrowing rate the purchase option becomes more attractive, even in the short term.

While it is clear from the above that investing in property causes an excessive cash drain on the underlying business, there appear to be no suppliers of long term finance. This partly reflects concern by lenders that where properties are located outside the main metropolitan areas the asset value may be close to zero if the occupier ceases trading.

### 3.3 Working Capital Finance

The analysis of working capital includes an examination of all current

assets and current liabilities. Current assets include stocks of all types, accounts receivable, cash and other short term securities, as well as other less significant items such as prepayments. Current liabilities consist mainly of accounts payable and bank overdraft.

Bank overdraft is the major source of finance for short term credit. This is an extremely flexible form of finance. Historically, nearly all bank finance to industry was in the form of overdraft facilities which were, in effect, long term sources of finance.

In 1972 the banks introduced term lending facilities in an attempt to distinguish between short and medium term sources of finance.

The relative importance of bank overdraft compared to total current liabilities has not changed significantly since 1978. However, bank overdraft relative to term debt decreased from 105% to 85% between 1978 and 1982. This reduction may largely reflect the continuing policy of the banks of requiring firms to distinguish between short and medium term requirements. In interpreting any balance sheet figures care must be taken as the overdraft recorded is likely to be substantially different from the peak overdraft requirements and also from the level of bank overdraft facility actually available.

The ratio of current assets to current liabilities (current ratio) has decreased marginally, from 1.45 in 1978 to 1.43 in 1982. Reflecting this insignificant change there have been no significant movements in the relative importance of stocks, debtors or creditors, when compared to sales.

#### Working Capital Ratios

These ratios are shown below for 1982 by size classification of loans.

Table 6  
Selected working capital ratios 1982

	£50-£250,000	over £250,000
Stocks as % of sales	16	17
Debtors as % of sales	21	21
Creditors as % of sales	18	20

Creditors slightly exceed the amount of stocks and fund about half of the total stocks and debtors.

In UK manufacturing industry the stock to sales ratio is the same as in Ireland. However, debtors as a percent of sales are approximately 15% by comparison with 21% in Ireland.

In Ireland, the average collection period is 77 days, whereas in the UK the period is 51 days. The current ratio is 1.32 in the UK compared to 1.35 in Ireland. In the US the current ratio is on average 2.0 for manufacturing industry. Creditors as a percentage of sales amount to 23% in the UK compared to 20% in Ireland.

The volume of production in manufacturing industry increased by 1.9% p.a. over the period 1978/1982. Over the same period wholesale prices from manufacturing industry increased by 12.6% p.a. Bank debt increased by 16% p.a. Since the increase in bank debt has exceeded the increase in sales it follows that each cash pound of sales is now carrying a higher level of debt.

#### *Debtors*

The number of debtor days outstanding in Ireland is very high at 77 days. While it is difficult to ascertain why this is the case, a number of the interviewees indicated that both State and semi-State organisations were extremely slow payers. While amounts owed by such organisations will ultimately be paid, it puts severe pressure on the companies in the interim. Companies frequently find it impossible to arrange additional overdraft facilities to cater for the mounting debts due from such organisations. The Government should insist on its organisations paying more rapidly rather than causing financing difficulties for industry.

Given the size of debtors in Ireland they represent a very significant liquid asset to the company, and yet the banks have been slow to devise specific financing systems for funding debtors. It is estimated that factoring accounts for the funding of only £20 million of debtors balances. There is only one major factoring company in Ireland, International Factors, a subsidiary of the Bank of Ireland.

Factoring does not appear to be viewed by users as part of a banking operation. Factoring tends to have a very bad image in Ireland and outside of the clothing trade, where it seems to be widely used, it is perceived as being a last resort form of finance for companies who are incapable of managing their own affairs or are in financial difficulties. This image is not a problem in other countries where specific funding of debtors is more common. If factoring were more closely identified with mainstream banking activities it might receive wider acceptance. *Some of the companies interviewed complained about the slowness of*

collection of debts by factoring companies and about the cost of using factors.

While specific forms of debtor financing are not widespread in Ireland, recent decisions in the English courts which suggest that banks may be able to obtain a fixed charge over debtors could greatly facilitate the development of such mechanisms. This would also help to counteract the increase in the importance of preferred creditors. Such creditors greatly reduce the value of floating charge security. This makes it much more difficult to finance working capital.

It is in the interest of both banks and borrowers that more imaginative ways of providing short term finance be devised to release company funds tied up in debtors, while at the same time giving the banks a more satisfactory form of security than a floating charge which has become heavily diluted by preferred creditors.

#### *Stocks*

Stocks represent a somewhat smaller proportion of sales than debtors (16% vs. 21%). Over the last five years there does not appear to have been a liquidation of stock as one might have expected in a recession.

As with debtors the primary form of bank financing used to fund stocks is the bank overdraft. Stocks are not convenient security for a bank. However, in some situations banks can take security over stocks which are reasonably marketable, e.g. agricultural produce, paper, metal stocks, vehicles or finished goods. As with debtors it would seem that both banks and borrowers would benefit from a greater use of financing mechanisms tied directly to stocks themselves. Greater use might be made of warehouse receipts, a type of financing common in the US.

In general, bank overdraft is an extremely flexible and useful form of banking facility. However, it is not linked into the financing of specific stocks and debtors although, obviously, it finances the two in aggregate. The floating charge has become a less useful form of security for the banks, and as company demands for working capital to finance growth increase, there is a greater need for the banks to devise financing mechanisms geared to the funding of individual stocks and debtors. (Since creditors fund roughly half of current assets, bank overdraft — if linked to the financing of specific stocks and debtors — would have a security margin of the order of two to one.) While this sort of ratio is certainly required to give banks adequate cover for stock financing, it would be more than adequate coverage for debtor financing.

### VAT at Point of Entry

The imposition of VAT at point of entry was discussed with all the companies interviewed. A number of those interviewed had made representations to the Government in favour of introducing VAT at point of entry. The intent in looking for VAT at point of entry was to redress a situation which unfairly discriminated against the domestic manufacturer in favour of the overseas supplier. Even those who had sought the introduction of VAT at point of entry, though they still strongly believed in it, felt that insufficient care was given to its implementation.

Consequently, in nearly all cases, the imposition of VAT at point of entry was viewed as a major nuisance. This was particularly so in its initial phases, though the more recent refinements have reduced many of the imperfections. In particular the exemption for companies who are substantial exporters has been a major help.

Further refinement in the application of VAT at point of entry is still necessary. Some anomalies encountered were:

- (i) One of the IDA's most successful indigenous service companies found that when they rented a £150,000 machine for a week from the UK that they were obliged to pay VAT at point of entry on the capital value of the machine, which was 10 times the cost of renting the machine for the week.
- (ii) A manufacturer of drugs for sale on the Irish market was required to pay VAT at point of entry on imported packaging while his foreign competitor could import the finished product including packaging without any VAT at point of entry.

The imposition of VAT at point of entry in theory imposes an additional working capital financing requirement as VAT must be paid in advance. This is certainly true for the company which is entirely up to date in its normal VAT payments. However, for many companies the payment of VAT at point of entry simply brought them up to date on their VAT payments.

In all cases VAT at point of entry has had the effect of increasing working capital requirements. The evidence from our survey is that this increased working capital requirement has caused problems for many companies. It would seem that banks are unwilling to increase overdraft facilities to cater for the increased financing needs.

There is some evidence of importers warehousing stocks in Northern

Ireland in an effort to defer payment of the higher levels of VAT in Ireland.

When discussing VAT at point of entry many companies felt that its implementation was symptomatic of a whole range of anti-business attitudes which seemed to permeate Government and administrative actions. They felt that the environment for business in Ireland was bad and that the barriers put in their way by the bureaucracy, in the day to day conduct of their business, seemed completely at variance with the plethora of agencies established to grant aid and develop manufacturing industry. A recent Economic Intelligence Unit report would appear to lend strong support for the view that Ireland is one of the worst environments in the EEC for small business.

### 3.4 Export Financing and Foreign Exchange

Before discussing the various types of export financing schemes it is important to examine the destination of Irish exports, the sources of imports and the trade balances with the various countries. These are shown in Table 7.

Table 7  
Irish exports and imports by destination and source in 1982

Country	Exports £000	Exports %	Imports £000	Imports %	Trade Balance
UK	2,205	39	3,274	48	-1,069
W. Germany	532	9	522	8	+ 9
France	495	9	315	5	+ 180
Netherlands	296	5	258	4	+ 38
Italy	166	3	180	2	- 13
Belgium/Luxembourg	254	4	148	2	+ 106
Denmark	39	1	55	1	- 17
Greece	25	1	7	-	+ 18
EEC Total	4,012	71	4,760	70	- 748
USA	407	7	876	13	- 469
Canada	69	1	83	1	- 14
Other areas	1,200	21	1,093	16	+ 107
	5,688	100	6,812	100	-1,124

Source: CSO.

The important thing to note about this data is that 83% of exports go to European countries and North America. The implications of this destination profile from the point of view of export insurance is obvious, i.e. the level of political risk for the vast bulk of our exports is low.

Multinational companies account for nearly 70% of total Irish exports.

The import statistics highlight that the major trade deficit amounting to almost the equivalent of the total trade deficit is with the UK where the deficit was £1 billion in 1982. The second largest deficit area is the US with a deficit of £469 million.

#### *Export Financing Schemes*

There are basically three export financing schemes in operation in Ireland. These are:

- Medium-term finance for Capital Goods Exports
- Short-term finance for non-Capital Goods.

These three schemes are similar to those operated in other countries and, in particular, are similar to schemes run by the British Export Credit Guarantee Department, the acknowledged experts in the business. The Industrial Credit Company also operates a working capital for Exporters Scheme.

#### *Export Insurance*

The purpose of export insurance is to provide assistance to the exporter by reducing risk of loss from non-payment and through the insurance policy to provide a basis for financing exports. Appendix 32 shows the destination of exports that have been insured. It is consistent with the overall distribution of exports with a concentration in Europe and North America. Appendix 33 shows that approximately 8% of Ireland's exports in 1982 were insured. This compares with 30% in the UK, but is comparable with some of the other European countries such as Italy and Holland. Export insurance consists of:

- (i) Insurance against political risk:  
This basically insures the exporter against loss due to a political action beyond the control of his customer which results in the exporter not being paid on time. This could result from political strife or non-payment by an importer due to lack of foreign currency in the importing country. Typically this risk is a factor in the lesser developed countries and is not a major issue for the vast bulk of Irish exporters.
- (ii) Insurance against credit risk:  
This basically insures the exporter against the risk of non-payment due to his customer being unable to meet the payments for financial reasons. Clearly this type of insurance is extremely important.

#### (iii) Letters of credit:

While not strictly part of export insurance it is appropriate to mention that where an exporter can persuade his customer to open a confirmed Letter of Credit in his favour then there is no need for insurance. This process is by and large simpler and quicker than insurance cover and can be dealt with through normal banking channels. An exporter should start by seeking confirmed letters of credit from his customer and it is only when this route has failed that he should turn to insurance.

*Medium-Term Finance for Capital Goods Exports:* This scheme has been in existence for a number of years. Through it the exporter can obtain finance at non-market rates for periods of 1-5 years. Typically, the purpose of this scheme is to allow the exporter to offer extended credit terms to his customer while obtaining immediate payment himself. The contract being financed must be covered by an export insurance policy before being eligible for the scheme.

The scheme has not been widely used in recent years as shown by the figures below – the finance available is 80/85% of the value of goods being exported:

#### Amounts Financed – Capital Goods Export Scheme

	£m
1978	7.4
1979	8.1
1980	13.0
1981	15.0
1982	22.5

These figures are miniscule compared with total exports of £5.7 billion. There are a number of reasons for this. The first and obvious one is that the country is not a big exporter of capital goods. Secondly, until this year the Associated Banks were the only ones operating the scheme. They made little or no effort to promote it and its availability was, therefore, not widely known. This is regrettable since export financing is a vital component of successfully selling capital goods overseas. In defence of the banks it should be said that the scheme operated required them to subsidise export finance. Clearly, one cannot expect an institution to aggressively market a product on which they will lose money. In the UK and in the US banks have been heavy promoters of ECGD and EXIM schemes and have been innovative in suggesting ways of improving the schemes. This has not been the case in Ireland.

Recently the Department of Industry, Trade, Commerce and Tourism has made significant improvements in the scheme. However, some degree of subsidisation is still required from the banks and it would appear that the Associated Banks still do not aggressively market the scheme. Under the revised scheme non-Associated Banks participate and some are beginning to market it actively.

The interest rate which applies to the Capital Goods Scheme has a maximum set by agreement among OECD countries. While member countries tend to abide by these rules in terms of the stated interest rate on contracts there is evidence that widespread breaking of these rules takes place through various additional schemes not always published. A favoured mechanism is to provide "foreign development aid" to importing Governments as a means of reducing the interest cost on export credit to the buyer. It is suggested that if Ireland is to be successful in competing for capital exports then a more "pragmatic" approach will have to be taken to their financing.

In summary, the scheme that now exists is comparable to those offered in other countries. However, the operation of the schemes elsewhere is at considerable variance to the stated terms. If this country is to be competitive some means must be found to ensure that exporters of capital goods are not at a disadvantage in terms of the finance offered. We suggest that if the wholehearted support of the banks is to be obtained, they should not be required to subsidise the scheme in any way.

*Short-Term Finance for Non-Capital Goods:* This scheme did not exist until two years ago. It is, however, the scheme which will have the greatest applicability to Irish exporters. Basically, it provides 180 day finance to exporters who have obtained export credit insurance. The interest rate charged is a margin of 1% over the money market rate for the currency in which the goods are invoiced, where the goods are financed by a non-Associated Bank. The four Associated Banks by agreement among themselves require a margin of 1.5%. This scheme should be a significant source of working capital to exporters. As with the capital goods scheme the Associated Banks have done little to market it and, indeed, do not yet appear to have printed brochures. The non-Associated Banks have participated in the scheme since summer 1983 and it is hoped that they will provide the marketing impetus that has been lacking to date.

*Some General Comments on Export Finance and Insurance:* (i) In promoting these insurance schemes the Government, as underwriter,

assumes all of the risks. In theory it will attempt to match the premium income against underwriting losses. Nearly all European export insurance operations have experienced very difficult times in recent years and have suffered significant losses.

(ii) Users of export insurance have a clear preference for insuring only the high risk exports and not all of their export turnover. In theory exporters are required to insure their entire export turnover but in practice this is not the case. There is an obvious conflict between the desires of the Government to run a financially prudent scheme and the demands of exporters for insurance to cover only their higher risks. It is suggested that where exporters wish to insure only a portion of their overseas sales a more flexible approach be operated with a much higher level of insurance premium being charged for higher risk countries.

(iii) The operation of export finance schemes requires input from three different institutions, namely, the exporters bank, the Insurance Corporation of Ireland (ICI), now owned by AIB, and the Department of Industry, Trade, Commerce and Tourism. During the structured interviews frequent complaints were received about the length of time it takes for an insurance/finance application to make its way through the system. If the 180 day scheme is to work properly, the bureaucratic process must be reduced significantly. As policy maker and underwriter, the Department of Industry, Trade, Commerce and Tourism determines which countries it will insure and within that country which credit risks it will assume. The bank as provider of finance is clearly an essential party to the transaction. The ICI function would appear to be, largely, an administrative one. They process the insurance applications, assume no underwriting risk and are paid a management fee by the Department to whom they pass on all premium revenues and underwriting losses. Since the type of insurance work involved is not of the actuarial type, but rather banking or credit risk assessment (the Department does the political risk assessment) the insurance company's role is primarily administrative. In an effort to reduce the paperwork for exporters, to speed up the application process, and to reduce the number of institutions the exporters have to deal with, the Department of Industry, Trade, Commerce and Tourism should take over the functions currently in the hands of the ICI. This would be consistent with the British export scheme which is run by ECGD — a Government Department reporting directly to the Minister of Trade.

(iv) While the non-capital goods scheme has been substantially improved by the Department over the last couple of years, there are a number of issues which still cause problems. The first is that the scheme is entirely

dependent on the use of Bills of Exchange. For many companies it is impossible to obtain Bills of Exchange from their customers. This is particularly true in developed countries and with large and sophisticated buyers. If the scheme continues to have a requirement for Bills of Exchange a large section of the exporting population for whom it was intended will not be able to use it. Some means must be found to overcome this impediment.

The figures below taken from a 1982 CTT survey reinforces this point.

**Table 8**  
**Terms of payment for Irish exporters**

	Open account %	Cash against documents %	Letters of Credit %	Bills of Exchange %
UK	91	4.5	3	3
USA	78	10	11	3
West Europe	76	11	11	10
Africa	21	20	59	7
Middle East	12	15	73	3

(v) Where an exporter is using the short-term finance scheme his foreign exchange risk is eliminated because he receives immediate payment in Irish pounds.

(vi) It is accepted that political risk can increase and that the Department may wish to remove certain countries from insurance cover. However, there appears to have been cases where exporters found insurance cover removed in mid-contract, leaving the exporter exposed to a risk which he thought he had insured against.

The problem has been practically addressed and is catered for by Comprehensive Contracts Policies which cover the exporter from the date of contract where the exported goods cannot easily be redirected to other markets. The policies cost approximately 10% more than standard cover and preclude the insurer from changing the terms of insurance once the contract is in place. To a lesser extent this removal of cover was applied to the exporter with ongoing business in a country which is likely to continue despite changed political circumstances.

(vii) The absence of insurance cover for interest accrued while a claim is being processed presents a problem for banks. The effect is that the bank/client is responsible for interest on the claim for up to 12 months. At high rates of interest this can be a significant exposure. Some adjust-

ment in the scheme to cater for this difficulty is needed. There is some evidence to suggest that where a customer of the bank has export insurance or short term export finance, the banks do not adjust the customer's credit limit upwards to reflect the fact that a portion of the company's borrowings are now guaranteed by the Government.

(viii) There are several other smaller issues which must be ironed out in the scheme, e.g. an exporter paying an insurance premium for 180 days when he is in fact being paid by his customer in, say, 30 days; an Irish exporter, currently receiving export credit insurance, who sets up an overseas distribution company can no longer avail of the insurance where sales are routed through that company. This problem has now been addressed by new wording introduced earlier this year into insurance contracts.

*Performance Bonds:* It is possible under the export insurance scheme for an exporter who has been required to provide a bond related to the performance of the contract, to obtain insurance against the unfair calling of the bond. The issuance of bid bonds, tender bonds and performance bonds is an area which requires a high degree of expertise. The Associated Banks are usually extremely reluctant to issue performance bonds without considerable security. Some of the Continental banks, however, have been active in this area.

Government support under the Irish Performance Bond scheme is considerably less than that available under ECGD schemes. This area is being examined to determine the extent to which demand for performance bonds is not met at present by the banks.

In general, exporters are ignorant of existing export finance and insurance schemes and many believe that the Irish schemes are inferior to overseas export schemes.

A serious marketing effort is required from the banks to inform customers of the details of the schemes and to contribute to the refinement of the schemes so that they operate efficiently and are suited to the needs of the Irish exporter.

#### *Foreign Exchange*

In a CTT survey of 1,400 exporters in 1980, only 20% indicated that they made use of forward markets. This statistic must be interpreted with care as nearly all the companies interviewed for this report defined their foreign exchange management policy as one of removal of all exchange risk. Some small indigenous companies interviewed indicated



that they were not aware of the existence of forward foreign exchange markets and their possible use for protection against exchange risk.

A number of issues concerning foreign exchange arose in the company interviews:

- (i) Companies felt that the paperwork relating to obtaining foreign exchange cover had increased substantially in recent years. This is undoubtedly true, particularly since Ireland joined the EMS. As the EMS system has been working smoothly for some time now, the Central Bank should review its foreign exchange regulations as they apply to foreign trade with a view to liberalisation of the regulations and a reduction in required paperwork.
- (ii) Some firms felt it would be helpful when tendering for overseas contracts to obtain some form of option on foreign exchange cover. They perceived a significant foreign exchange exposure at the point of tendering which could not be covered under the present foreign exchange regulations.
- (iii) For firms engaging in contracts exceeding one year the present Central Bank rules for foreign exchange cover are restrictive. It is acknowledged that the further forward one goes in time the thinner become the foreign exchange markets and the more difficult it is to obtain a quote from the market. Nevertheless, the demand for forward cover on such contracts is likely to be small, and it may be that the Central Bank can devise a scheme to facilitate exporters. If a similar facility were available to importers a degree of matching might be possible.
- (iv) A number of firms interviewed felt that the regulations governing the operation of foreign currency hold accounts which required conversion of most foreign currency balances into Irish pounds every month is too restrictive and did not reflect their terms of trade.

### 3.5 Summary

Manufacturing industry is experiencing difficulty attracting equity funds due to the high return which can be earned on alternative lower risk investments. The higher returns outside manufacturing, which are due mainly to tax biases which exist in the system, cause funds to flow into Government Gilts, Property and Insurance-Linked Unit Trusts.

Many of the distortions which exist in this risk/reward relationship have arisen, over the years, due to the introduction of different fiscal incentives designed to solve individual problems as opposed to being introduced having regard to the total potential set of investments. It is necessary to find some mechanism whereby unnecessary distortions do not re-occur in the future. Unless these distortions are removed, manufacturing industry will not attract significant investment funds, and even then only if adequate profitability is achieved.

There is a high level of investment in fixed assets in Irish industry. If this investment is to yield an adequate return profitability in manufacturing industry must improve. Despite this, however, companies had little difficulty in financing their fixed assets. Insurance companies and pension funds played little part in financing manufacturing industry.

Compared with renting, investment in land and buildings imposes a heavy cash drain on companies in the early years of ownership. In the period of the high inflation during the 1970s ownership did yield high returns. However, in time of lower inflation this is not the case.

There has been a reduction in reliance on overdraft as a means of financing companies in the period 1978-82 and a consequent increase in term lending.

The position of the State as a preferred creditor has increased the risk to banks who are providing working capital finance to manufacturing companies. This has had the effect of making the financing of working capital more difficult for companies.

The application of VAT at point of entry was seen by many companies to be a major operating nuisance. It did increase the working capital requirements but banks were reluctant to increase overdraft limits to accommodate these increased needs. There are still certain anomalies in the operation of VAT at point of entry which need further examination.

The Department of Industry, Trade, Commerce and Tourism has made substantial improvements in the Export Credit Schemes available to exporters. There is now a need for banks to market these schemes which they have been reluctant to do in the past. Since the role of the ICI in Export Credit Insurance is primarily an administrative one and since all decision making rests with the Department, the Department should take over the operation of the entire scheme.

Some relaxation in Exchange Control regulations as they relate to trade

would be appropriate in order to improve service to exporters and reduce paperwork.

## **CHAPTER 4**

### **FINANCING NEEDS AND THE FIRMS LIFE CYCLE**

The financing needs of manufacturing industry vary considerably depending on the size of firm, its stage of development and its ownership.

In this section the financing needs of four different types of firms are examined. These include:

- New ventures
- Small and medium sized enterprises
- Large indigenous firms, and
- Foreign firms

#### **4.1 New Ventures**

Venture capital is a widely abused term. It has been used extensively, and incorrectly, to describe several different types of finance for a new enterprise. The term has also been used to describe loan finance from both banking and other sources to new enterprises. Debt finance, from whatever source, should never receive the title of venture capital irrespective of how widely the term is interpreted.

To improve understanding and eliminate much of the confusion which exists in relation to the funding of new ventures the financing of new ventures may be divided into three distinct phases. These are:

- Seed Capital
- Venture Capital
- Development Capital.

Seed capital is the first phase of financing, i.e. the stage where one is financing the development or testing of an idea or concept. The second phase is the venture capital phase, in which finance is required to bring the concept into commercial production. Development capital is the third phase and is the finance which will allow a company to move from being a small to a medium sized enterprise. Following on the development stage, the company should grow into a large enterprise capable of being financed through the stock market.

### *Seed Capital*

The emphasis in seed capital is on financing ideas and concepts. Funds are required for researching the idea, developing a prototype (if appropriate) and bringing the concept to a stage where a commercial product or service has been defined. Funding is largely required to determine the likelihood of the idea or concept being commercially viable. Much of the expenditure is required to fund the promoters' time and research activities. The amount of expenditure may be substantial because of the potentially long time lag between the conception of the idea and the determination of its potential for success. This seed capital stage is of an extremely high risk nature. Consequently, the only appropriate source of funding is equity finance.

The seed capital stage is the first point in the development chain of new business. Without this initial phase there would be no subsequent demand for venture or development capital and no increase in the industrial base. In recognition of this the National Science Foundation in the US has set up a programme designed exclusively to help firms at the seed capital stage.

All seed capital should be in the form of either equity or surrogate equity such as grants. Loan finance is not appropriate due to the high level of risk. US evidence suggests that the likely failure rate is 90%.<sup>1</sup> Ideally, seed capital should come from the person with the concept or his friends and those living in the immediate community. Given the biases which exist in the risk/reward relationship in Ireland (see 3.1) only an irrational investor would provide such funds. As a consequence only 12% of the funds are provided by the promoters, as compared to up to 60% by the State, in Enterprise Development Programme (EDP) companies. In the continued absence of seed capital funds there will be few projects coming through to either the venture or development capital stage. To generate a pool of seed capital within the community it will be necessary to correct the existing series of distortions in the returns available from different investments. In addition, recognising the extremely risky nature of seed type finance, positive inducements are necessary to attract investors to this initial stage of company development. This inducement should take the form of a 100% write off of seed capital expenditure against an individual's income tax. The amount of this write off should diminish over time to reflect the reducing uncertainty as the concept is developed. The write off should decrease by 5% p.a. subject to a lower limit of 75%. This seed capital phase should cease for the purpose of these seed capital write-offs once

the IDA agrees to grant-aid the company (other than feasibility or research and development grants).

### *Venture Capital*

This is the second stage in the funding of a new enterprise. Finance is required to get the concept from the feasibility study stage into commercial production. This phase is likely to last for a period of 3-5 years. During this time the company is likely to have a very substantial cash drain. It may easily suffer significant trading losses (everything seems to take twice as long and cost twice as much), as it attempts to develop its new product markets. The areas for which funds are required by the fledgling company are:

1. Capital Expenditure (plant, buildings and vehicles) – usually correctly quantified
2. Start-up Costs (legal, accountancy, etc.) – usually ignored
3. Research and Development – usually underestimated
4. Working Capital (around 27% of turnover for manufacturing) – very rarely appreciated
5. Running Losses (for up to 3 years) – always underestimated.

The venture capital stage is less risky than the seed capital stage. In the US research has shown that 60% of all new firms fail within the first five years of commencement. While the risk of failure is lower than in the seed capital stage, because of the much larger amounts of funds involved aggregate exposure is likely to be higher. As with the seed capital stage the finance for the venture capital stage should come primarily from equity or grant sources. It is totally inappropriate to have large amounts of borrowed funds.

As with seed capital, Irish investors are unwilling to provide venture capital. There are a small number of exceptions to this, where finance from Pension Funds, Insurance Companies, and Venture Capital funds have supported new start-up companies.

Without removing the distortions in the risk/reward ratio it is unlikely that there will be a significant increase in this type of funding. Given the almost total absence of equity funds for venture capital the IDA identified the need to support new ventures and set up the Enterprise Development Programme (EDP) in 1978.

### *Enterprise Development Programme*

The EDP was intended to stimulate entrepreneurship among executives from industry, with a view to their starting their own manufacturing

<sup>1</sup> ... .. Bannister, Polytech, Troy, N. York.

businesses in the high growth sectors of the economy, and in particular in areas of high technology.

At the end of 1982, 85 projects were in operation, employing 1,300 people. An estimated 40 to 50 new projects will be approved in 1983. Interestingly, the promoters of these new projects continue to come from secure jobs in industry and are seldom unemployed executives. The total investment in EDP was £50 million at the end of 1982.

While it is clearly too early to measure the success of the EDP programme in commercial terms, it must be considered a success in terms of the number of new ventures in operation, which are unlikely to have been established in the absence of the programme.

As with all start-up ventures, those going through the EDP have experienced a high rate of failure. US research shows a 60% failure rate over the first five years, and a 35% failure rate in the first two years. A recent study<sup>2</sup> of 59 firms which were established under the EDP programme in the period 1978-80 indicated that some 30% had either failed or been substantially restructured, by June 1982. Of the 96 projects which were set up under EDP from 1978 to February 1983, some 24% have ceased operations or been substantially restructured. About half of these (i.e. 12% of all projects) have been restructured and are once again in operation. These failure rates are not inconsistent with international experience, and at this point in time could not be considered unreasonably high. The true failure rate will not be clear for a number of years. However, care must be taken not to unduly focus on failure rates. It is easy to eliminate failures by not taking any risks.

A company faces two types of risk, business risk and financial risk. In a new venture business risk is very high and every effort must be made to ensure that the company does not take on additional financial risk. Accordingly, debt financing should not be an important element in the funding of new ventures. The business risk in new ventures is greatly aggravated by the heavy cash drain in the early years. Consequently, equity is the most appropriate form of finance for new ventures.

In the absence of equity finance for new venture investment the typical financing profile of EDP companies is as follows:

Equity	12%	) ——— IDA Exposure
Grants	32%	
Borrowings guaranteed	24%	
Borrowings not guaranteed	32%	
	<u>100%</u>	

The total risk to the IDA in the form of grants and loan guarantees is 56%.

For the new venture the loans are subject to full interest charges and have to be repaid. The guarantee is only relevant as security to the bank if the company fails. This failure is made much more likely by the imposition of the additional cash drain of borrowings, relative to the cushion of equity finance.

Borrowings at 56% of funding is a totally inappropriate form of funding for a new venture. It substantially increases the risk of failure.

#### *EDP Cash Flow Analysis and the "Valley of Death"*

High technology based projects have significant cash flow deficits in the earlier years. This period is sometimes referred to as the "Valley of Death" – a period which many companies fail to survive. If successful, however, the turnaround to positive cash flow comes quickly, and tends to grow at a rapid rate. On the other hand, lower technology projects tend to have smaller negative cash outflows in the earlier years and if successful, show a slower rate of growth than the high technology companies.

Figure 2<sup>2</sup> is based on an analysis of cumulative cash flows of EDP projects during the first three years of operation. The projects are divided into those in high technology and those in low technology activities. As expected, the higher technology projects have a larger deficit. Both, however, are still in significant cumulative cash deficit positions.

Figure 3 shows the effect on the cumulative cash flow of the sample of high technology projects if they rent their factories, instead of purchasing them, and if they are financed with equity rather than debt, where no dividend payments are made until after the company has a cash surplus.

<sup>2</sup>The Implications of Financial Structure and the Performance of Start-up High Technology Based Companies in Ireland, Barry McGovern, unpublished M. Comm. Thesis, 1983.

<sup>2</sup>The Implications of Financial Structure and the Performance of Start-up High Technology Based Companies in Ireland, op. cit.

Figure 2

Enterprise Development Programme: Analysis of cumulative cash flows of high and low technology projects over the first three years of operation

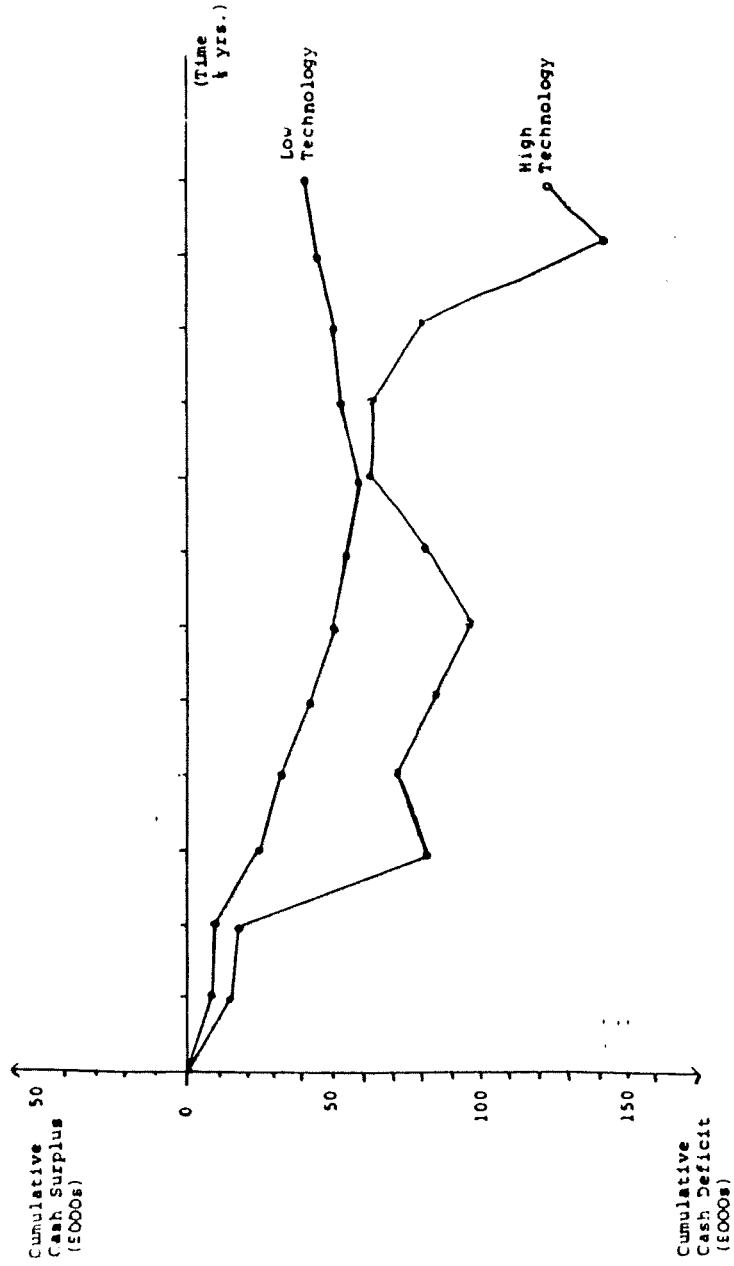
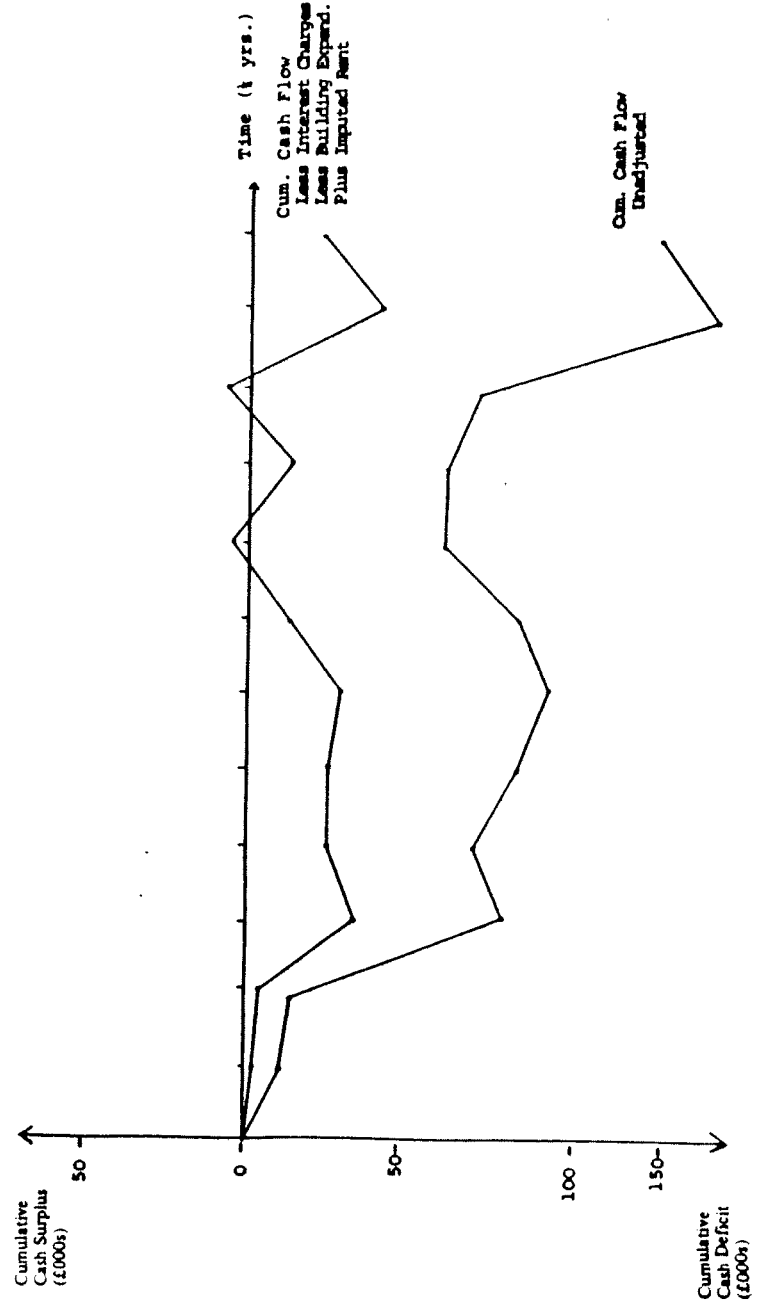


Figure 3

Analysis of cumulative cash flows of Enterprise Development Companies over the first three years of operation



While the number of companies in the sample, at 5, is small this figure does illustrate the dramatic effects of a proper capital structure and the avoidance of unnecessary capital investment. There is some evidence to indicate that in the past banks put pressure on companies to purchase their premises to provide security for bank lending. Recognising the seriousness of the cash drain resulting from the purchase of property the IDA no longer allow those involved in EDP to purchase their buildings. There is also some evidence that the higher technology companies supported by the EDP programme have tended to manufacture low technology products, and are involved in significant amounts of distribution and agency work, in an effort to generate immediate profits and cash, with a view to servicing the bank debt. This is done at the expense of innovation, research, and new product development.

#### *Venture Capital – Management and other Problems*

Many new ventures are by their nature lacking in management depth. The promoter may be an expert in production, marketing or finance but never an expert in all three. There is a clear need for outside management support in those areas where the promoter is weakest. The IDA have recognised this and prefer to have projects involve promoters with complementary skills and if possible joint venture and licensing arrangements.

It is clear from the analysis of EDP companies that equity is the sensible form of finance. However, some of the institutions indicated that the financial advisors to many companies totally failed to appreciate the importance of using a proper mixture of debt and equity in the company. Such advisors tended to take the limited view that ownership was the most essential factor, even at the expense of the likely future growth or success of the company. This emphasis reflects an inadequate appreciation of the greatly increased likelihood of failure of the company because of the cash flow problems caused by using debt rather than equity finance. Start-up projects are very risky. Taking on the avoidable financial risk of debt makes these companies even more risky.

#### *Venture Capital – A New Environment*

There is a need to encourage equity investment in new venture companies, as it is only in a situation of financial strength that a company can develop new markets and grow. This implies a willingness both on the part of investors to provide venture capital funds, and on the part of the promoters to share the equity investment with financial backers.

Problems with the risk return ratio and the need to correct these biases have already been discussed. A 100% tax write off for seed capital

investment was proposed and a similar write off for venture capital investment is warranted. For venture capital the write off should start at 75% diminishing by 5% p.a. to 50%.

In other countries with a higher rate of company tax firms have been encouraged to raise new equity through the medium of a corporate tax write off. In Ireland this is not an appropriate inducement as the level of tax in manufacturing is now 10%. However, requiring all IDA grants for companies in the venture capital stage to be matched with an equal amount of new cash equity investment, would probably provide the necessary inducement.

#### *Development Capital*

The third level of financing is the finance to move from small to medium size on route to a stock market quotation and development into a large enterprise. There are a number of venture capital firms seeking to invest development monies in companies with high growth potential. These include Development Capital Corporation, Allied Combined Trust, Share and Loan Trust, First Venture Fund, ICC, Avenue Investments, and Silvermines Ltd.

The number of projects brought to venture capitalists has increased in the last few years but remains at a low level overall. This reflects the lack of seed and venture activity which must precede the development phase.

While the bulk of ordinary Irish manufacturing companies lack equity capital for development the venture capitalist seeks high growth companies and has no interest in investing in the average Irish manufacturing company. There is a need for further equity finance for these firms. Fifty percent of new equity investment in companies in existence for more than five years should be allowable against income or corporate tax. Given the size of the Irish market it is almost inevitable that companies seeking development capital will move into international markets. It is very much in the interest of the economy that such capital be available to fund the growth of these companies.

#### **4.2 Small and Medium Size Enterprises**

The definition of what constitutes a "small" firm varies depending on what Government agency is supplying the statistics. The IDA use a criterion of 50 employees, An Comhairle Oiliuna a level of 80, and the Irish Productivity Centre and ICC a level of 100. The Small Firms Association uses an employment level of 100. In the US a small firm is defined by the Small Business Association (SBA) as employing 500

people or less. However, if we define small as those employing 100 people or less then small manufacturing firms represent 94% in 1981 (88% in 1980) of all Irish manufacturing companies and provide 38% of the employment in manufacturing industry. In Japan the equivalent figures are 98% and 56% respectively. The numbers clearly indicate the importance throughout the western world of small firms. Table 9 shows comparative figures indicating the importance of small firms in various countries.

**Table 9**  
**Importance of small manufacturing industry**  
**(Employing 1-99)**

Country	Year	Small Enterprises as a % of total	Employment in Small Firms as a % of total	Turnover of Small Firms as a % of total
Germany	1970	97.0	28.0	—
Belgium	1970	96.9	33.2	—
Denmark <sup>1</sup>	1973	87.1	36.3	—
France <sup>2</sup>	1976	92.9	25.2	24.5
Ireland <sup>3</sup>	1980	87.5	37.5	30.0
Italy	1971	98.7	47.3	—
Luxembourg	1973	94.9	19.1	—
Netherlands	1973	95.6	36.0	—
UK	1972	90.1	16.2	13.2 <sup>(5)</sup>
US	—	—	—	—
Japan	1976	98.0	56.0	34.0 <sup>(1)</sup>
Canada <sup>4</sup>	1974	88.0	33.0	25.0 <sup>(3)</sup>

**Notes:** <sup>1</sup>Firms employing 6-99.  
<sup>2</sup>Firms employing 0-99.  
<sup>3</sup>Firms employing 3-99.  
<sup>4</sup>Data refers to all business firms.  
<sup>5</sup>Relates to 1968.  
<sup>6</sup>Numbers in brackets refer to the rank order of importance of the small firm in the countries listed.

**Source:** EEC Commission and IDA.

The importance of the small firm has been recognised internationally. In the US, Government fosters an environment supportive of small firms through the Small Business Association (SBA) and Small Business Investment Corporations (SBIC).<sup>3</sup>

The importance of small business was also recognised in Britain by the Wilson Report which noted that lack of equity in small business was a constraint to growth. Recent UK tax legislation which allows individuals to write off equity investments in business has sought to redress this

situation. In the US and Japan support for small firms is not limited to manufacturing industry and in the UK the recent Small Business Expansion Scheme (BES) covers not only manufacturing but also distribution businesses.

Over 800 projects per annum are approved under the Small Industries Programme in the IDA. Some 80% of these are expansions of existing companies rather than start-ups.

Not surprisingly, the vast majority of Small and Medium Sized Enterprises (SME's) are in medium and low technology activities — the metals and engineering sector accounts for 45% of IDA grant approvals to small industry. The IDA estimates that only about 5% of small enterprises can be expected to have significant growth potential. These firms should be identified and provided with every encouragement to grow. It was outside the brief of this study to examine what, other than financial aspects, stops companies from growing. In particular many companies appear to reach a size of about 50 employees and then stop growing. While the lack of finance is clearly a constraint, based on our observations, it appears that there are many other factors which are also of relevance. These include the quality of management and the lack of mobility and experience of management. The lack of external expertise which, in other countries, is usually a part of any package providing external equity, and the development of lifestyle companies where there are few incentives to develop beyond a particular level. A comprehensive analysis of what stops small companies becoming large should be undertaken.

As a group Small and Medium Sized Enterprises are unlikely to attract equity from venture capitalists due to their lack of "star" appeal and the stock market is not a source of equity. As with the rest of manufacturing industry, small firms lack equity and they rely heavily on grant agencies and on banks to provide them with finance.

The survey of companies suggests that small firms have greater difficulty in dealing with their banks than larger companies (see Chapter 6). There are probably many reasons for this, ranging from lack of sophistication on the part of the small business to a lack of understanding on the part of the banks. The small firm is most likely to deal with the local bank manager who cannot be expected to be an expert in manufacturing.

It is desirable that manufacturing companies have a primary relationship with a bank officer who specialises in manufacturing. This would

<sup>3</sup>State of Small Business, A report to the President of the United States, March 1983.

particularly benefit small manufacturing companies. We have recommended elsewhere that when banks reject a loan application they should provide reasons for the negative response. This would assist the small manufacturing company. The recommendation that companies make better use of outside Directors as a simple and inexpensive way of obtaining advice and guidance is particularly applicable to small firms. Indeed, some of the companies interviewed felt strongly that their use of professional advisors or Directors to deal with banks and development agencies had been a key to their success.

The 1981 CTT export audit showed that 66% of all exporters employed less than 100 people and that these accounted for £750 million of exports or 15.7% of total Irish exports. In examining those companies interviewed which had less than 200 employees we found that 50% had no qualified financial manager. These companies generally did not make use of the forward exchange markets and had made little use of export credit financing arrangements.

In 1979 a US Small Business Administration study<sup>4</sup> on incentives for increasing small business exports highlighted three barriers to exporting which would appear to be equally applicable in Ireland. These were:

- (i) Owners and managers of manufacturing firms had an inadequate knowledge of export incentives and the methodology of international trade.
- (ii) Next to the lack of knowledge, fear of the added risk of exporting was the most significant barrier to beginning international trade.
- (iii) Difficulty in obtaining adequate export capital was especially acute for the small rapidly growing manufacturing firm that is a primary candidate for international export activity.

An interesting feature of the SBA in the US is the use of an Affirmative Action Programme designed to increase the share of contracts awarded by US Government agencies to small business firms. Such a programme could be operated in Ireland to the benefit of small firms with a likely import substitution spin off. Some attempts have been made in this direction in the past but this does not appear to have been systematically organised.

<sup>4</sup> Incentives from increased Small Business Exporting, Robert Pricer, University of Wisconsin, 1979.

### 4.3 Large Indigenous Companies

Large companies in this study were those in excess of 200 employees. They would not be considered to be large by international standards, but there are only 115 indigenous manufacturing companies in Ireland in this size category. These companies account for 30% of the labour force in indigenous manufacturing industry.

The interviews suggest that finance is not a material constraint for large Irish companies. These companies appear satisfied with their banks. They are not reliant on a single bank and the larger company is likely to have several banks competing for its business.

The large company typically has a high level of financial expertise. It normally deals with the bank's Head Office. The combined expertise works to the advantage of both the company and the banks, the company making suggestions as to its needs and the Bank Head Office staff having a clear understanding of the range of products that it can offer to the company.

In theory, the larger firms should have ready access to the Stock Exchange as well as to bank financing, but in practice this has not been the case. The Stock Exchange has been largely irrelevant in satisfying the equity needs of Irish industry (see Chapter 5.1).

The Co-operative Societies are among the largest Irish businesses. Due to their ownership structure new equity comes from their membership and they have found it very difficult to raise the amount of equity appropriate for businesses of their size. The lack of equity may restrict some of the Societies from developing the new products and new markets which are essential if they are to grow through export market expansion.

The financial position of large companies has significantly deteriorated over the past few years. A recent survey of the 25 largest quoted industrial companies<sup>5</sup> showed that the return on capital employed (Profit Before Interest and Tax divided by Capital Employed) fell from 15.5% in 1979 to 11% in 1982. Over the same period Profit Before Tax to Capital Employed showed a much greater decline falling from 13% to 7.5%. This indicates the substantially increased impact of interest costs.

While large companies, in general, do not have problems in dealing with their banks, most do provide security in the form of either fixed or

<sup>5</sup> Goodbody & Wilkinson, Aggregate Accounts, 1983.



floating charges. However, banks appear to be willing to share this security.

Equity finance has not been readily available to the large companies. In common with all sections of manufacturing industry these companies also suffer from a lack of equity.

#### 4.4 Foreign Firms

These fall into two categories – subsidiaries of large successful multinationals and subsidiaries of much smaller firms with a very limited overseas presence. Historically, the larger firms dominated foreign investment in this country. This may now be changing as many of the new technology firms are recently formed and still at an early stage of development. This trend may also be the result of the IDA broadening its marketing effort to include smaller firms which were not the primary target in the past.

The Irish subsidiaries of foreign companies have been very profitable (with some notable exceptions) and, as a result, their financing needs tended to be a good deal less than for their Irish manufacturing counterparts. Their primary need for finance is for fixed asset investment. This is typically financed by a one-third grant matched by equity, leaving a third to be financed through bank borrowings, normally in the form of leasing. The interviews indicated that these companies had no difficulty in raising their fixed asset financing requirements. Their primary concern was with the cost of financing, and, here, leveraged tax-based leasing was an extremely competitive and attractive form of financial incentive.

It is difficult to estimate the extent of foreign companies' working capital requirements since many purchase raw materials from affiliates and sell finished goods to other affiliates. This allows them to "manage" their working capital requirements to ensure that the group maximises its borrowings where the cost is least. Section 84 type financing provides funds at an advantageous rate and multinational firms made extensive use of this. This cheap tax-based financing is essentially an additional form of grant aid and the cost should be assessed in quantifying the total package provided to any individual company.

In the future, foreign companies coming to Ireland are likely to be smaller than those who set up here in the past. In many cases this may be their first move overseas. Their smaller size has important implications for both their financing needs and their ability to raise finance.

To date, it would appear that these new companies, frequently in the area of electronics and software development, can only raise finance from the Irish banks by providing guarantees from their main US bank – in the case of American companies – or the equivalent for other countries. The Irish banks reasonably argue that if the company's home bank is unwilling to support the overseas move by its client with its consequential risks and borrowings then the company should not be setting up an overseas operation. It is unfortunate that in taking this approach the Irish banks do not have the motivation to develop expertise in the new technology sectors these companies are bringing to Ireland. A point of some concern is a number of cases where smaller firms setting up in Ireland were told at a late stage in their negotiations with the banks that while tax-based lending was available its availability was entirely dependent on their home bank guarantees or guarantees from foreign banks located in Ireland.

It is clear that foreign industry in Ireland makes extensive use of foreign banks located here for their international trading transactions. Equally, because the bulk of foreign companies operating here are production units with little or no marketing responsibility, their use of CTT services is small in relation to the value of their exports.

In general, multinational firms have very little difficulty in obtaining funds at very competitive rates, but this is usually because funds are provided on the security of a guarantee from either the parent company or a foreign bank.

#### 4.5 Summary

The logical cycle in the development of companies is to move from seed capital, to venture capital, and then on to development capital. These stages represent the idea generation, commercialisation and initial growth phases of a company. Due to the high risk nature of ventures at the seed capital stage and the biases which exist in the risk/reward relationship the rational investor will not invest in businesses which are still at the idea or concept stage. The same is true for companies in their first five years of commercial production where the risk of failure is still high. At both the seed and venture stage, financing through bank debt is inappropriate as it adds high financial risk to a company which already carries high business risk. The financing prospects for companies who have progressed to the development stage and show signs of high growth is, however, quite favourable. Venture capital companies are eager to invest in such high growth companies but cannot find a sufficient number of candidates. Since the majority of Irish manufacturing companies do not have high growth prospects they do have difficulty in

attracting equity capital to fund growth and expansion.

To encourage the provision of capital for companies at the seed, venture and development stages, tax write-offs should be available to investors.

The IDA Enterprise Development Programme established to encourage executives to set up new venture in high growth industries will approve 45 new projects in 1983. At a time of deep recession this performance indicates that the programme has been successful in achieving its basic objectives.

There are, however, some problems with the ventures set up under the EDP programme. The level of bank debt in these companies is far in excess of what is appropriate at this stage of development. As a result many of these companies are obliged to engage in low technology manufacturing and assembly to generate sufficient cash flow to service bank debt. There is four times as much debt as equity in the EDP companies. A more appropriate capital structure for these new ventures would be to have four times as much equity as debt. Given the very high failure rates which are to be expected at the EDP or new venture stage, much of the bank debt to these companies has all the risk characteristics of equity, without any of the potential rewards.

The financial data presented earlier in the report indicates that small firms were more profitable than larger ones and had a better financial structure. The importance of small firms to the economy is seen from the fact that firms employing under 100 people represent 94% of all Irish manufacturing companies. There is a need for the IDA to identify those small firms with growth potential and to encourage their development.

The large indigenous company was less likely to have difficulty in raising bank finance than the small one. Bank finance has been readily available to large companies, despite the lack of adequate profitability.

There is a need for co-operatives to develop new products and new markets. This product/market expansion requires the availability of equity-type finance. Such funds are not readily available due to the ownership structure of the co-operatives. If these societies are to realise their market potential some mechanism should be found to provide them with additional equity-type finance.

## CHAPTER 5

### SOURCES OF DIFFERENT KINDS OF FINANCE

In this section the available sources of long, medium and short term finance are reviewed. The equity area appears to be the component which is largely missing from Irish financial structures. This occurs for many reasons, some of which have been highlighted earlier in the report.

#### 5.1 Equity

The average level of gearing (Bank Debt/Shareholders Funds) in Irish manufacturing companies is 59%. This compares with 49% in the US, and 51% in the UK. Smaller UK manufacturing companies in the Wilson Committee sample had a gearing ratio of 38% when directors loans were considered to be equity. There are significantly different gearing levels across sectors of US industry. Sectoral trends are not as clear in Irish manufacturing.

Most of the firms interviewed had been funded from the original owners equity, with no new equity injections, other than retained earnings. Considerable use may have been made of property revaluation as a means of increasing capital reserves during the 1970s. Increases in a company's net worth have thus been a mixture of retained earnings and property revaluations, with little new money coming in as new equity investment. Sixty percent of the managing directors of the companies interviewed did not perceive a need for additional equity, even when they found it impossible to fund what they perceived as essential expenditure from either bank or IDA sources.

While the issue of control of the company was probed, most companies had not thought sufficiently about their capital structure for the control problem to be a significant issue. However, when further pushed on the issue most felt that they did not wish to dilute their control over a business they had developed.

The Stock Exchange has not been an important source of funds over the past decade. In total £233 million (a substantial percentage of which went to the non-manufacturing sector) was raised on the Stock Exchange

since 1972. In the same period borrowing by the corporate sector increased by £1,040 million.

The corporate financial data (Appendices 2 to 25) shows an increase in the amount of issued capital in all sectors. It is not clear whether this is a result of equity being introduced or some other factor such as capitalisation of reserves, originating from revaluations of land and buildings.

Only a small number of existing companies have had significant injections of new equity in recent years. This is not surprising as returns in manufacturing have been low and risks high compared with alternative investments.

Pension funds and insurance companies have not been a source of equity except for a limited number of start-up or high growth ventures.

#### Sources of Equity

The major sources of equity finance are as follows:

- Private investors/promoters, including retained earnings
- The Stock Exchange
- Venture Capital Companies
- Pension Funds and Insurance Companies
- IDA and other Development Agencies
- Rescue Agencies

#### *Private Investors/Promoters*

It is important to distinguish between the business promoter and other private investors. Business promoters will generally provide as much equity capital as they can afford. However, they can seldom provide, on their own, the levels of equity required to support a business. This is particularly true in Ireland where the level of disposable income is low. To the extent that industry relies solely on promoters' equity then industry will be severely undercapitalised. This is largely the current position.

Private investors who should have an important role in providing financial backing to promoters have not been significant investors in Ireland. The concept of investment pooling through a corporate structure does not generally exist. This is in contrast to earlier years in the State when the idea of collecting contributions in a local community to support a business project was effectively used.

The general lack of involvement of private investors in providing equity to manufacturing industry is due to:

- (i) The very low level of profitability in manufacturing industry. Just why manufacturing industry profitability is so low is not clear but it is certainly influenced by the recession and by a difficult business environment. It is vital to recognise that profit is necessary for survival and for investment. Non-profit making enterprises cannot survive indefinitely no matter how prepared Governments may be to reject additional capital.
- (ii) The low level of disposable income in the country.
- (iii) The very high tax free return available from alternative risk free investments such as Government Gilts.
- (iv) A lack of incentive for business promoters to involve other financial backers.
- (v) The lack of a tax incentive to make an investment in manufacturing industry in the first instance and the high levels of tax on both dividends and capital gains. Any advantage gained by the company due to the low level of manufacturing tax cannot be transferred to the owners of the company. This contrasts with the old tax free export status where the benefit to the company could be passed on to its owners.

#### *The Stock Exchange*

In recent years the Irish Stock Exchange has not been a source of capital for most of Irish manufacturing industry. It appears to have two primary functions:

- (a) to provide a market in stocks which are already quoted, and, even here, the thinness of the market makes it difficult to trade in many shares with the result that when large blocks of shares change hands the transactions tend to be arranged outside of the floor of the Exchange;
- (b) to provide a market for Government Gilts which represent the vast bulk of turnover on the Exchange. In the first quarter of 1983 turnover by value in Irish Government Securities accounted for 99% of total turnover. In terms of number of transactions, Irish Government Securities represented 61% of the total number of transactions.<sup>1</sup>

In the context of the need for equity in Irish manufacturing industry it is disappointing that the Stock Market is a source of equity for only a

<sup>1</sup>Central Bank Bulletin, Report No. 1, 1983.

handful of Blue Chip companies. The reasons for this are many and most of them beyond the control of the Exchange itself. They include the low profitability of manufacturing, a low level of awareness of equities as an investment medium amongst the Irish public, and the availability of low risk high returns elsewhere.

However, the Exchange has not been innovative in responding to the needs of Irish industry. This is evident in reviewing the performance of the Stock Exchange as a source of capital over the last 10 years. This is shown in Table 10.

Table 10 indicates that since 1970 a total of only £5 million has been raised for new manufacturing companies coming for a full listing on the Exchange. Ninety three percent of the money raised through rights issues went to the Banks, Cement Roadstone Holdings, The Smurfit Group and Waterford Glass Limited. The issues for cash were placings with financial institutions which primarily related to acquisition activities by large companies.

Table 10  
New Capital Raised on the Stock Exchange – Irish

	Rights issues £m	Public Issues		Issues for Cash £m
		Gross value of shares issued £m	Net cash proceeds to company £m	
1970	0.4	—	—	—
1971	1.7	2.8	1.5	0.5
1972	8.5	1.4	0.6	7.2
1973	6.4	6.4	2.9	0.8
1974	10.2	—	—	—
1975	17.2	—	—	—
1976	22.9	—	—	—
1977	18.2	—	—	—
1978	0.6	—	—	0.9
1979	42.5	—	—	0.4
1980	2.6	—	—	0.2
1981	53.5	—	—	14.1
1982	3.6	—	—	17.1
Total	188.3	10.6	5.0	43.7

Source: Issue documents published by the individual companies. The statistics quoted in the Central Bank Quarterly refer in some cases to nominal capital not actual money raised. (Compiled by J. Hogan.)

The Stock Exchange has not been a source of equity for new companies. Memory Computers is the only Irish manufacturing company to come

to the Unlisted Securities Market (USM) in Ireland. However, to achieve a successful flotation Memory deemed it necessary to make its initial flotation through the London Exchange.

Three other companies have come to the USM in Dublin. These are Fruit Importers of Ireland which raised £2 million, Woodchester Investments which raised £1 million and Bula Resources which raised £12 million. None of these companies are in manufacturing industry.

There has been much discussion of the success of the USM. However, the equivalent facilities were, effectively, available under Rule 163 (2). The main difference would appear to be the positive effort by the Stock Exchange in London to promote the USM.

A recent study on the Irish Stock Exchange by Colbert & McCarthy,<sup>2</sup> states:

“Our analysis reveals a spectacular decline in the number of quoted companies brought about by mergers and sectoral decline. There is no reason to believe that the decline will be arrested in the foreseeable future. The composition of those remaining must also give rise to some unease. A number are public in name only and are rarely traded. Nor does the total number constitute a significant element of the Republic’s industrial and commercial sector. Of the major Irish companies ranked by turnover published in Irish Business, January 1980, only 17 of the top 100 are quoted on the Stock Exchange. None of the major enterprises in agribusiness, or the new industries established by subsidiaries of foreign companies, are ever likely to avail of its services. Consequently the Exchange is highly unrepresentative of the broad range of activities conducted in the economy.”

The Stock Exchange has become increasingly irrelevant as a source of capital to all but the handful of companies who have a joint listing on the London market. The total funds raised through rights issues or new issues for Irish manufacturing companies has averaged less than £1 million p.a. Over the period 1969-1981 total additions to the new equity markets amounted to £223 million. This compares with £440 million invested in commercial property development and £1,600 million of Government Stock issues to the non-bank public.

<sup>2</sup>Colbert & McCarthy, The Irish Stock Exchange Company Quotations 1950-79, Irish Business Administration Review, Vol. 2, No. 2, October 1980.

Since the establishment of the link between the Dublin and London Stock Exchanges only one company has achieved a full listing and it failed to raise its targeted amount. This is not to say that the link was the sole reason for this. Furthermore, there is a growing tendency to completely by-pass the Dublin Exchange and to place shares directly with the institutions – primarily pension funds.

#### *Venture Capital Companies*

The basic objective of venture capital companies is to invest in "large companies which are now small". Clearly their interest is in high growth situations with the prospect of high payoffs. Typically they invest in companies which are already in production and are in need of equity financing to fund growth and development.

The venture capital company's portfolio is a mix of manufacturing, distribution, property, retail and services companies. Ideally, a candidate company will have potential to obtain a listing on the Stock Exchange.

In addition to providing finance, venture capital companies also provide considerable management support to the investor companies and play an active role in guiding the company's strategy.

A number of venture capital funds operate in Ireland. These include Development Capital Corporation, Avenue Investments, Silvermines and the Banks. The Banks participate, either directly as is the case with ICC or through venture capital funds managed by the Merchant Banks e.g. Allied Combined Trust (ACT) and Share and Loan Trust (SALT).

While the bulk of their funds have been directed towards developing companies, venture capital companies have made some investments in start-up ventures including Trilogy, Stephens Green Safe Deposit Co. and Intest. On balance, however, there appears to be a shortage of investment opportunities for existing venture capital companies. While the number of projects which they review has undoubtedly increased in recent years they do not have the supply of companies in need of development finance and with the high growth potential they would like. This is partly a function of the lack of equity investment at the seed capital and start-up stages.

Funds from venture capital organisations to development companies is the one area where equity funds are readily available to manufacturing industry. All the existing venture capital funds have been established with banks, insurance companies and pension funds as shareholders. No

venture capital fund exists which allows individual shareholders to invest.

It is the basic business of a venture capital company to invest in growing companies, tying up their investment for years, after which the investment may be sold and the released monies invested in younger growing companies. It is not constructive to apply capital gains taxes on a company or individual who realises a profit on an investment and immediately re-invests the proceeds. A tax on all realised capital gains serves only to reduce the investment funds available by diverting a portion of the gains to the Exchequer. It is suggested that Capital Gains Tax should only be applied when gains are consumed and not when the gains are re-invested.

The tax reliefs suggested as appropriate for equity investment in seed, venture and development companies should be equally available to the investments of a venture capital company or fund as to individuals.

The EEC is developing a European Innovation Loan Scheme designed to increase the flow of venture capital from the private sector. Companies will qualify for loans under the scheme if an approved financial intermediary agrees to match the loan. This matching must take place in the form of either equity or a subordinated loan. Loans under the scheme will be available to small and medium sized companies developing new products, processes or services. The funds will be provided as a 10 year subordinated loan on which no security is required. There will, in effect, be a two year interest free period which will be financed from the Community budget. Unlike other EEC funds these monies will be available not just for funding fixed assets but also for funding working capital investment.

#### *Pension Funds and Insurance Companies*

The estimated total size of pension funds at the end of 1982 was £2,200 million. The estimated annual net cash flow of these funds (i.e. the total of investment income and new pension fund contributions) is £350 million. This cash flow figure is the main source of new investment.

Despite the size of these funds they are insignificant suppliers of finance to Irish industry. A 1981 survey by the Irish Association of Pension Funds showed the distribution of investments by Irish Pension Funds. These are compared with the UK Department of Trade figures for investment by UK Pension Funds. The figures are reproduced in Table 11.

Table 11  
Pension fund investment - 1980

	Ireland %	UK %
Cash and deposits	11.3	4.7
Government Stocks	40.8	21.6
Other Fixed Interest Stocks	4.3	6.5
Equities and Convertibles	15.7	50.0
Property	27.9	17.2
	100.0	100.0

In the above table the percentages are calculated using the market values of the investments at the end of 1980.

The major difference between funds invested in Ireland and the UK appears to be equity investment. Fifty percent of UK pension fund investment is in equities, whereas only 16% of domestic investment by Irish Pension Funds is in equities. This difference is mainly accounted for by a 26% higher investment in cash and gilts and a 10% higher investment in property by Irish Funds. In the US, American pension funds invest some 44% of their funds in equities, a further 22% in long term bonds (a mixture of corporate and government), 14% in short term deposits, and 3% in real estate. Mortgages count for 4% of their funds.<sup>3</sup> US pensions now invest 1% of their funds in venture capital activities. Guaranteed investment contracts and insured plans account for the balances.

In general, Pension Funds do not provide long term funds to industry. However, they have been willing to participate in high growth companies through investment in such funds as DCC, and ACT. They have also performed a useful role by participating in private placements which for one reason or another were not brought to the Stock Exchange. However, most Pension Fund Trustees are unwilling to become involved with individual investments unless a substantial number of other Pension funds also participate.

Because of the long term nature of both Pension and Life Office Funds, it is appropriate for such funds to invest in industrial buildings. This is not happening, except in prime locations. The difficulty with non-prime property investment is the danger of it being left unoccupied

<sup>3</sup>Goodbody & Wilkinson, Aggregate Accounts, 1983.

for substantial periods if the initial tenant cannot make the rent payments. This problem is further exacerbated by the surplus of grant-aided empty factories which helps to undermine demand.

A scheme might be developed to permit a flow of long term institutional funds into non-prime property. Such a scheme would require the bundling together of a large number of properties so that the funds would invest in an average property position rather than be exposed to the fortunes of a single unit. The IDA has the largest industrial property portfolio and the Pension Funds should be required to examine with the IDA how this portfolio or some portion of it could be transferred to the Pension Funds. It is probable that the rent payable relative to the value on such properties would be very high, however, as the rental income received by the funds would have to be sufficient to compensate for the probability that some of the properties would not be rentable if the current tenant were to leave. Any scheme developed would of necessity have to take into account the market realities both in terms of rental levels achievable and the valuations established given the total position of the industrial property market.

It is estimated that there were some 330,000 people covered by pension funds in 1978. Most pension fund holders have little identification with their pension funds and the investments which these funds make. If pension fund holders were more aware of how their monies were invested they might develop a greater understanding of both the needs and the importance of industry.

#### *IDA and Other Development Agencies*

The IDA are considered in this section dealing with equity because their grant funding should be considered as quasi equity. In the absence of other equity sources it has been a major source of non debt funds to manufacturing industry. The financial survey of companies provided in Table 1 indicates that IDA grants amount to approximately 8% of shareholders' funds. This understates the total value of the grants, however, since the grants are written off over 10 years on the company's balance sheet. Furthermore, it understates the equity value of the grant at the time the asset was acquired. There is no doubt but that the grants provided by the IDA have been of enormous assistance in funding fixed asset investment and in providing a margin to secure bank borrowing.

It is inappropriate, however, for manufacturing industry to rely on the IDA for its equity funds. This has been the case in the past as there is little evidence of company's shareholders' funds increasing through equity

injections from promoters or investors. The financial survey shows some increases in shareholders' funds, but this arises largely from capitalisation of re-valued assets.

The IDA's total investment in 1982 in the form of grants and building expenditure was in excess of £200 million. It is essential that funds of such magnitude be allocated as efficiently and as effectively as possible. Consistent with the overall objective of the IDA of wealth creation it makes economic sense to discriminate in favour of those companies who perform well.

It is, therefore, desirable to establish a system under which companies could only expect a favourable response to grant applications in situations where they have achieved objectives previously agreed with the IDA. The establishment of appropriate mechanisms for evaluating company performance is a difficult one. Different performance criteria/targets may be appropriate for companies at different stages of development and in different industries. Given the small size of the Irish market it is not possible for companies in the traded sector to develop into significant commercial enterprises without ultimately developing overseas markets.

Companies who are incapable of significant export potential and who justify their continued existence on the basis of long term import substitution should not be supported. This is particularly the case where there is any possibility that a different company, under different management might develop into these export markets. Grant aiding companies which purely service the domestic market does nothing more than provide a subsidy for one company relative to the others. Grant aiding all such companies artificially depresses the costs of the total industry, and causes a misallocation of resources. Consequently the only companies which should be grant aided are those whose ultimate objective is the development of export markets. Import substitution is a reasonable short term objective, as firms need to be of a reasonable size before they can take on the additional risks and demands of export marketing.

This report has emphasised the inadequacy of the equity base of Irish manufacturing industry. In other countries inducements are provided for companies to raise new equity by providing special corporate tax allowances. The low level of Irish manufacturing tax militates against the success of such a scheme. In Ireland an inducement could be provided by requiring that all grants be at least matched by new cash equity injections. This is consistent with IDA practice at present in

relation to foreign companies setting up in Ireland who are required to match IDA grants with an equal amount of equity.

While the IDA have clearly filled a void in the equity markets through the provision of grants, there must be some concern that owners of firms are frequently reluctant to introduce new equity particularly where there is ready availability of IDA grants and bank loans. This is particularly true in the case of financing fixed assets. The existing requirement that grants be tied to fixed assets has resulted in a high level of capital investment in Ireland. The same cannot be said for investment in product/market development which, while essential for long term wealth creation, is frequently not grant aided and non-bankable. The high level of investment in fixed assets will only be justified if markets are developed to fully utilise the assets.

Other countries, such as the UK, the Netherlands and Belgium, while providing lower levels of fixed asset support do provide support for product market development. In Ireland, State responsibility for product market development rests primarily with CTT. The IDA is responsible for fixed asset financing. To ensure rational allocation between aid for fixed asset financing and product/market development finance a much closer liaison is necessary between the IDA and CTT.

(The services provided by SFADCO and Udaras, being virtually identical to the IDA, have not been separately discussed.)

#### *Rescue Agencies*

In recessionary times rescue agencies play a significant role in financing manufacturing industry. Decisions regarding the financing of companies in difficulty are complex. They involve inevitable trade-offs, between financial risk and social responsible, and between the cost of creating a job and the cost of saving one. While a rescue package may solve short term problems the real objective of a rescue is to create firms with the capability for growth and development in the post-rescue period. It is pointless to create a portfolio of the "living dead" and policies in the rescue area should be aimed at providing the rescued company with a reasonable opportunity for medium term growth and development.

There are two types of company rescue:

1. Takeover Packages
2. Re-financing Packages

Company takeovers will normally result in a fundamental change of

ownership. Re-financing packages, the majority of cases, occur in all other circumstances.

There are essentially three rescue agencies. Two are in the rescue business on a voluntary basis, namely Foir Teoranta and the IDA. The third is the Revenue Commissioners who is an involuntary participant in the rescue business. All, however, are State agencies and therefore should have the same objective. Tables 12 and 13 below show the commitment by the IDA and Foir Teoranta to rescue operations for the period 1980/1982.

Table 12

IDA Rescue Division statistics

	No. of companies	Total grant commitment	Grants for takeovers	Grants for re-financing	Employment saved
1980	65	£8 million	£5 million (29 firms)	£3 million (36 firms)	3,000
1981	74	£32 million	£12 million (31 firms)	£20 million (43 firms)	7,495
1982	114	£28 million	£13 million (38 firms)	£15 million (76 firms)	7,740

Table 13

Foir Teoranta Rescue statistics

	No. of companies	Loans provided	Employment saved
1980	50	£10 million	8,800
1981	35	£5 million	4,000
1982	80	£14 million	7,700

In 1982, £42 million of State aid went into Company Rescue. This figure will be higher in 1983 both in terms of the number of companies rescued and the amount of funds provided.

This £42 million does not take any account of significant sums owing to the Revenue Commissioners which will never be repaid due to company closures or because the firms will never be capable of repaying sums owed to the Revenue Commissioners. We are unable to quantify the State's contribution to Rescue via the Revenue Commissioners. However, it is not unusual for firms coming to the IDA for Rescue assistance to owe more to the Revenue than they do to the IDA and the banks combined.

There is difficulty in quantifying the cost per job rescued in that while both Foir Teo and the IDA claimed to have saved about 7,700 jobs each in 1982 there is bound to be a substantial degree of overlap between these two organisations. There is a need for a co-ordinated approach to the business of Company Rescue between these agencies with the objective of one agency being responsible for the overall Rescue effort.

It is important decisions rest with only one agency since, in the past, a certain amount of negotiation occurred between Foir Teoranta and the IDA as to what their respective contribution would be, with each side, presumably, seeking to minimise their own contribution.

Since early 1983 a system has been worked out between Foir Teoranta and the IDA which has eliminated inter-agency conflict and leaves Foir Teo as the primary mover in rescue situations. The IDA operates an early warning system and seeks to identify potential Rescue situations. These cases are discussed at weekly meetings with Foir Teo and the Department of Industry, Trade, Commerce and Tourism.

Our overall goal is to ensure a single responsibility for the allocation of State funds where some form of rescue is necessary. Responsibility will rest either with the IDA or Foir Teoranta depending on the type of rescue activity.

In company takeover situations, the IDA should play the lead role. This essentially involves the establishment of a new business and the IDA is best positioned to find suitable candidates (both domestically and overseas) to set up these new enterprises. Although it is unlikely that Foir Teo monies will be required in a takeover situation occasions do, however, arise where they are called on to assist. It follows, therefore, that it is appropriate for the IDA to keep Foir fully informed from the beginning in all rescue cases of a take-over nature.

In the case of re-financing packages, Foir Teo should play the lead role. We would, however, also see the IDA playing a significant role in advising Foir Teo on the appropriateness of rescue in cases of re-financing packages.

It is clear that the IDA will have considerable sectoral knowledge and will be aware of the strategic importance, or lack thereof, of the industry. The IDA will, in all probability, have had a close relationship with the rescue company over the years and will have an understanding of its ability to compete successfully in its market-place. The IDA input,



therefore, to the decision-making process is most important. However, the final decision in a re-financing rescue rests with Foir Teo.

#### Revenue Commissioners

The Revenue is an involuntary participant in the rescue business. However, in many cases, companies seeking rescue assistance have aggregate amounts owing to the Revenue which exceed the combined amounts owing to the IDA and banks.

While monies owed to the Revenue provide a short term source of working capital they also provide management with a soft option of not facing cutbacks when a downturn in business requires this. The effect has been unhealthy from everybody's point of view. The Revenue Commissioners found themselves in the position of choosing between collecting monies owed, and thereby putting companies into liquidation, or of holding back and allowing themselves to become a primary source of finance to ailing firms. This position was facilitated by the preferential position of Revenue debts.

The Revenue Commissioners are not empowered to forgo any amounts of funds owing to them and at best can provide the concession of deferring payment over a period of three years. The size of the Revenue monies owed allied to the short term over which they must be repaid, when the firm is at its weakest, can ensure that the combined efforts of the IDA and Foir Teoranta cannot succeed in rescuing the company.

Where large amounts of money are due to the Revenue, Foir Teo cannot put an effective rescue in place without removing the tax overhang. In many instances commercial banks are unwilling to provide essential loans due to the prior claim nature of Revenue debt. Foir Teo should take over responsibility for paying off the sums due to the Revenue, and allow rescued companies to repay these to Foir Teo over an extended period.

#### Appropriate Financing for Rescue

The bulk of Foir Teo funds to industry are in the form of loans at market interest rates or preference shares. However, in 1982, interest paid to Foir Teo on loans outstanding (after provisions for bad debts) amounted to only 2.8%. It follows that Foir Teo is not earning a commercial rate of return on its loans and it may be that Foir Teo should recognise this by providing soft loans to rescue companies in exchange for equity. It is suggested that Foir Teo take direct equity investments up to and not more than 26% in companies which come to it for rescue in exchange for whatever amount of loan funds, at zero

interest rate, may be appropriate to the rescue situation.

With a favourable loan package the rescued company stands a much greater chance of survival and development in the medium term. Hopefully this will give value to Foir's equity holding and in the long run might prove a more remunerative use of Foir's funds. Providing funds at commercial interest rates to these companies reduces the likelihood of their survival due to the higher debt servicing requirement.

It is recognised that one of the fundamental issues in a Rescue situation is to determine whether the cost of a job saved is greater or less than the cost of a job created. If Foir are to be the primary Rescue agency they must have the responsibility for calculating the cost to the State of the job saved including the cost to the State of redundancy payments, unemployment payments and funds owing to the Revenue if the company were to go into liquidation.

Given that the ultimate objective of Rescue is to create firms capable of growth and development in the medium term the following points must be made:

- (a) In Rescue situations where large sums are owing to the Revenue the continuance of Revenue debt effectively precludes the ultimate objective being achieved.
- (b) More debt is not what a company in need of Rescue requires.
- (c) In practice, Foir Teoranta receives only a fraction of the interest due to it. The borrowing firm for its part while failing to make the cash payments due to Foir Teoranta must charge the full interest cost (say 15%) to its profit and loss account, thereby guaranteeing continuing losses.

A re-think of the Rescue operations should take place along the following lines:

- (a) An effective Rescue cannot take place with large sums owing to the Revenue. Some way must be found for extending the payment terms and reducing the interest cost on these funds. We believe that Foir Teoranta should assume responsibility for funds owing to the Revenue.
- (b) Foir Teoranta should recognise the reality that the provision of loan funds at commercial interest rates is unlikely to be a successful formula in rescuing companies. Foir Teo has attempted to address this problem by providing preference shares with deferred dividend payments. However, the problem

with this mechanism is that it builds up a large future debt which may block future development since the owners perceive that they are no longer working for themselves.

It is suggested that Foir take direct equity investments up to and not more than 26% in companies which come to it for rescue in exchange for whatever amount of loan funds at zero interest rate may be appropriate to the particular Rescue situation.

In this scenario it is not clear what role IDA grants play or indeed to what extent IDA grants are appropriate where there is a clearly defined State agency responsible for re-financing rescue cases. If the IDA were not to be a grant provider for Rescue situations, at least until they reached a development stage once more, then it would be appropriate that some of Foir Teoranta's loan money would be made available in the form of non-repayable loans (which is the equivalent of a grant).

## 5.2 Long Term Finance

Long term finance means loans repayable over periods in excess of seven years. Long term finance is attractive from two points of view. First, it reduces the pressure on companies to repay debt over shorter periods than justified by the payback on the project being financed. Second, long term finance was frequently provided in the past at fixed rates of interest thereby providing a degree of certainty in the financing costs of a project. At present neither long term finance at variable interest rates or long term finance at fixed interest rates is available for industry on the Irish market. There is one exception to this for manufacturing industry. The Industrial Credit Company (ICC) has available ten-year fixed rate money from the European Investment Bank (EIB) which is lent to small and medium-sized businesses. There has been great demand for these funds and their availability has been of great assistance to small industry. It has also been a very attractive product for the ICC who had sole access to these funds and it has allowed them to expand their lending base significantly.

The absence of long term money is a relatively recent phenomenon and is clearly linked to the growth in inflation over the past two decades. For almost a century and a half covering the period 1800 to 1950 Americans were willing to lend their money to the Government or to private companies for periods as long as 30 years at a 2-3% nominal interest rate. The only time this changed was during or immediately after wars and then only briefly. The ability to borrow money for 30 years at low interest rates made possible 30-year plans and 30-year write offs. Today this has changed, not just in the US, but in the

western world in general. A high degree of uncertainty about economic performance means that few lenders are willing to take a 10-year perspective let alone a 30-year one. Even where the funds are available for 10 years or more there is little chance of their being available at a fixed rate which does not include a substantial premium to protect the lender against the devaluation of his capital by inflation. If fixed rate funds were available to a manufacturer, it is unlikely that the return on the project being financed would be adequate to repay the interest which would currently be demanded by the fixed rate lender. The absence of long term fixed rate monies is therefore not critical since few manufacturing firms would wish to borrow at the high fixed rates of interest currently prevailing. Based on the interviews, firms would have been unwilling to borrow long term fixed rate money at rates above 10%, at a time when long term Government Gilt were yielding about 14%. It is questionable whether if all interest rates were to fall firms would still be prepared to borrow at a long term fixed rate of 10%. If there was demand then an interface, such as a mortgage bank, between pension/insurance funds and industry might be desirable.

The absence of long term finance for industry at variable rates of interest is certainly a concern. With profitability low, companies have great difficulty repaying capital amounts due on medium term loans provided by the banks. Banks are also concerned by this trend since the absence of loan repayments reduces the level of bank funds available for new loans. The financial survey indicates that while debt has increased significantly since 1978 the cash cover (net profits plus depreciation relative to debt) has not increased in the same proportion. Bank debt as a percentage of total assets has increased from 20% in 1978 to 22% in 1982, while net profits and depreciation have fallen from 1.2% of total assets in 1978 to 0.6% in 1982, a fall of 50%.

Banks should not be considered as major suppliers of long term funds since the bulk of their funds come from short term deposits and current accounts. Traditionally it has been the Life Assurance Companies and Pension Funds, whose sources of funds are long term, that have been willing to lend long term money. Few of these companies either here or overseas have been willing to lend long term funds in recent years despite declining inflation rates. It is unlikely that this position will change radically in the immediate future.

As indicated, at current high interest rates, long term fixed rate funds at commercial rates are not attractive to industry. One possible approach which could be attractive to both industry and lenders is a provision of index-linked funds with repayment of both capital and interest phased over the life of the loan.

The cash flow effects of this are depicted in Figure 4 below. This type of loan has the advantage of low interest charges in the earlier years, offset by the higher repayments during the latter period of the loan.

Using index-type funds ensures that the long term lender receives a real rate of return. During the seventies this did not happen. Such funds are ideally suited to property-type financing where one expects the rental value to increase over time also. There has been some move to develop sources of index-type funds. They were initially offered in Ireland by the Housing Finance Agency and are now also offered through two funds, one organised by a merchant bank, and the other by a life assurance company.

### 5.3 Medium Term Finance

Medium term finance is defined as loans repayable over a 1 to 7 year period and used primarily to finance buildings, plant and equipment, and vehicles. All banks provide this sort of finance, as do finance houses in the form of leasing and hire purchase. These funds are normally provided in Irish pounds but are also available in foreign currencies.

The financial survey indicated a significant increase in term finance as a proportion of total bank borrowings by Irish manufacturing industry. Term debt as a percent of bank borrowings has increased from 45% to 50% for small firms and from 52% to 57% in the case of large firms over the period 1978-1982. This trend is also confirmed by a survey of the top 25 publicly quoted industrial companies (Appendix 26).

This is not surprising as the Associated Banks have been pursuing a policy of reducing the use of short term overdraft facilities for fixed asset funding.

The interviews indicated that there was little problem obtaining funds to finance plant and equipment. This is partly explained by the positive impact which IDA grants have in providing a margin of security for the bank.

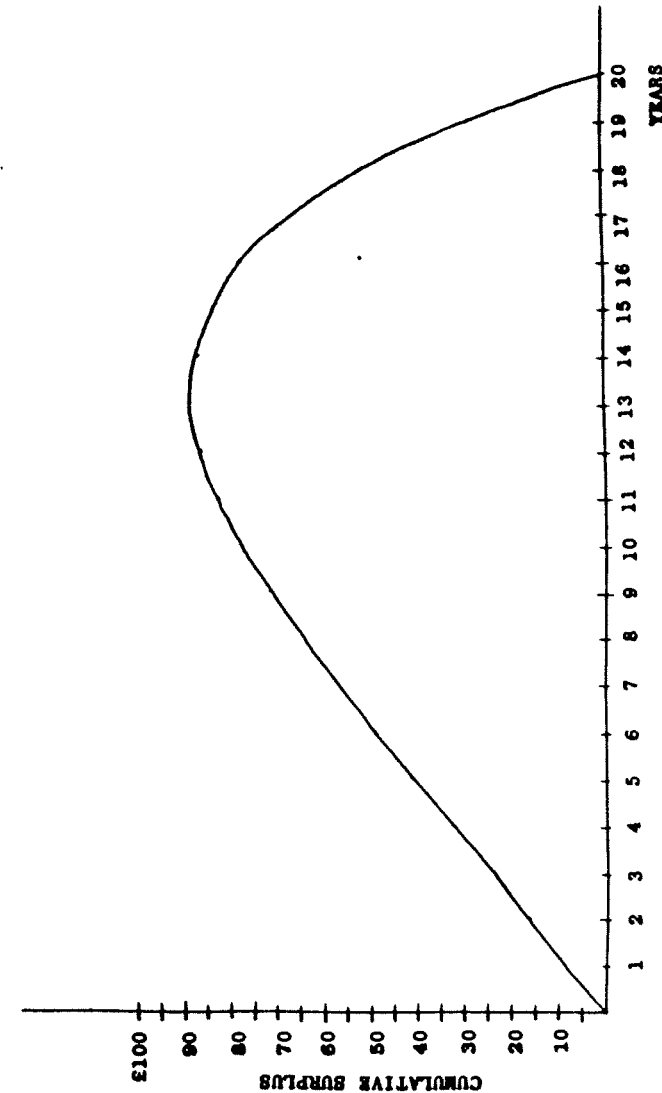
The industrial banks only provide about 1.3% of the loans to manufacturing industry. However, some companies indicated that it was easier to obtain a loan of say £20,000 from a Finance House (probably a subsidiary of one of the Associated Banks) than to obtain an increase of £20,000 in the company's working capital facilities via an increase in the overdraft limit. There are two reasons for this:

- (a) The bank places a high value on the security provided by equipment; and

Figure 4

Cash flow effects of repayment of Index Linked Funds loan

Cumulative surplus Cash-flow from using a 20 year Index-Linked loan of 2.5% versus a 20 year 12.75% fixed rate loan with level repayments of principal and interest, assuming a 10% inflation rate.



Example: After a period of 10 years, allowing for interest effects, the borrower will have £77.50 more cash available if the borrower uses an index-linked loan rather than a straight 20 year loan.

- (b) The rates of interest which they charge is likely to be substantially higher than that charged for overdraft or, indeed, for a 3-year term loan.

In quoting interest rates for hire purchase and leasing the finance houses/industrial banks continue to quote flat rates of interest. The law does not require that the true rate of interest be declared on such loans. However, the industrial banks have agreed with the Central Bank to display notices in their offices setting out both flat and effective rates of interest, relating to the facilities they offer. When quoting for business, be it verbally or in writing, and also in loan documentation, the banks and finance houses should be required to state the true interest cost to the borrower.

The more sophisticated borrower is capable of working out the true rates of interest and the effect of leasing tax write offs to the bank, and can negotiate appropriately competitive rates. This is not true, however, for the smaller company which can pay a very high rate of interest without appreciating this fact.

#### *Product/Market Development*

Traditional bank financing has had a strong security emphasis. As a consequence it has been oriented towards satisfying fixed asset and seasonal working capital requirements. There is no significant problem with the financing of these assets.

The area where there is a clear need for medium term funds (say 3 years) and where the market does not provide money is in financing company growth through product and market development programmes. As previously indicated, the level of fixed asset investment in Ireland has been high over the past decade. This investment will be pointless if products and markets are not developed to fully capitalise on the investment programme.

The financing of product market development is a risky business and should not be funded entirely from bank borrowings. There is a need for equity funds. There is also a need for a significant IDA and CTT involvement as their funds have many of the characteristics of equity investment. The final component in the package will be bank financing but this should not be dominant.

Bank funding for product/market development programmes will require a shift from security-oriented lending to cash flow-oriented lending. This shift requires much greater understanding of the individual com-

pany and sectoral needs by the banks. However, it will never be appropriate to fund all of the expenditure on product/market development with loan finance. The maximum appropriate amount of loan funding is the lower estimate of the amounts which the individual product/market development project is likely to realise. Financing in excess of this is more appropriate to equity-type funds. Coras Trachtala have proposed a Market Entry/Development Finance Scheme and we would fully support the objectives of such a scheme. In principle, however, we are not in favour of the use of State guarantees, as proposed in the CTT scheme, or in other State schemes. State guarantees are being used as a device to avoid focusing on the total amount of the State's liability. A greater sense of accountability would occur if instead of guarantees actual loans or grants to fund the costs were used. It is noted that in both the UK and French market entry/development schemes (see Appendices 37 and 38) the funds are effectively supplied in the form of repayable interest-bearing loans, where repayment is made through a percentage annual charge on the sales achieved.

In developing such schemes particular attention should be paid to the export services industries which by their nature have little to offer by way of security. It is worth noting that in our interviews the most widely perceived barrier to entering the export markets was the lack of finance, with ability to compete, due to wage costs and prices, being a close second.

#### *Product/Market*

The survey indicated a desire on the part of exporters for the expansion of the existing CTT programme for funding export personnel living overseas. This programme was seen as being particularly useful.

While it is easy to talk about the development of foreign markets from a conceptual point of view, in practice marketing in foreign countries is very demanding, requiring that an export manager live away from home for significant periods of time, often in unpleasant environments. In other countries income tax concessions are provided to export marketing personnel who spend more than 100 days a year abroad on business. This incentive is absolutely essential. It is people who generate sales and at the present levels of income tax in Ireland there is no inducement for an individual to undertake the rigours of export marketing when the personal gains are so few. Irish exporters have a serious problem in recruiting good people for this sort of work. This is certainly a barrier to the further development of exports from indigenous industry.

In the US a change in the law allows US banks to establish Export

Trading Companies. A number of banks have already done this, some setting up on their own, and others in joint venture with existing commercial firms. The concept is that if banks, who are experienced in financing global trade, were to bring together buyers and sellers, with the Export Trading Company taking title to the goods, then greater use of the banks' expertise and contacts would be made in the interest of promoting foreign trade. These Export Trading Companies are much too new for comment to be made on their performance. It does, however, show a willingness on the part of the US banking system to move a little in the direction of the Japanese concept of interlinking between financial institutions and trading companies.

#### 5.4 Short Term Finance

This is provided for periods of one year or under, typically through the medium of an overdraft. The overdraft is an extremely flexible and useful form of finance to the borrower. It is typically intended to finance seasonal working capital requirements. Additional forms of short term finance are provided via seasonal loans primarily in the agricultural sector. Apart from bank finance the other important source of short term finance is trade credit.

The information compiled by the banks for this study shows that there has been a decrease in the amount of overdraft financing relative to the amount of term financing over the period 1978 to 1982. In the companies with borrowings below £250,000 the ratio of overdraft to term finance has decreased from 55% to 50%. A similar trend is seen in the other sample of companies where the ratio has decreased from 48% to 43% in the period 1978-82.

While bank overdraft relative to term loans has decreased, the relative importance of overdraft as a source of short term finance has increased for small companies. In 1978 the ratio of bank overdraft to current liabilities was 19% in the small companies. By 1982 this figure had seen a marginal increase to 22%, about the same as for large companies.

Trade creditors provide about 29% of the total funding of Irish manufacturing industry. This proportion has remained unchanged over the period. For the large companies the average number of days taken has increased from 62 to 73. For the smaller companies the number of days has decreased from 68 to 67. Given the severe pressures on companies in recent years it is slightly surprising that the increase in the utilisation of trade credit has not been even higher.

Current assets relative to sales have remained roughly constant over the

period 1978-82 in both the small companies where the ratio is 42%, and in the large companies where the ratio is 40%.

While inflation has greatly increased the demand for working capital finances, the demand has been further aggravated by some actions of the State. In particular, the imposition of VAT at point of entry (see Chapter 3.3) has increased working capital needs. A particular problem is the method of charging VAT when there are stage payments involved. If one imports materials which will be paid for over a number of months, the VAT payment on the full value of the materials is still payable immediately.

A further problem which increases the demand for working capital is the substantial delay in the payment of IDA grants. In some instances delays were in excess of a year, though this may have been in part caused by the companies themselves. The IDA have a policy of paying grants within a period of six weeks from receipt of the claim. They believe that the actual delay from the time the claim is received to the payment of the grant is on average six to ten weeks. According to the IDA it is not uncommon to receive claims for grants in respect of expenditure incurred months or years prior to the claim date. However, if an average delay of six months is assumed in the payment of grants after the expenditure is incurred, and a 16% rate of interest, the value of the IDA grant is overstated by 8%. In general, there was little evidence of difficulty in arranging bridging finance for IDA grants. Some less secure companies, however, did have problems organising bridging finance because they had already used up their borrowing capability and the banks were concerned that if the company got into difficulties the money would not be forthcoming from the IDA.

Some banks have developed new products to cater for these problems. One has developed a special facility for bridging IDA grants, and a number of banks have introduced VAT bonds. However, there is also some evidence from our interviews that overdraft facilities were not revised to take into account the additional need for short term cash following on the introduction of VAT at point of entry.

Overdraft is a particularly flexible form of finance. However, while intended to be a form of revolving credit, it is frequently viewed as a source of permanent finance. In some other countries bills of exchange and promissory notes are the prime vehicles for short term finance. In many respects these are better from a bank perspective, in that they give much greater control over the business, but they are not as desirable as the overdraft from the point of view of the business.

The increased flexibility of the overdraft carries with it additional responsibilities. It is essential to develop a greater understanding between the bank and the customer. The arrangement of the overdraft should be subject to constant review based on the performance and needs of the company.

Entering into export markets provides additional working capital needs. The problems of export finance are examined in detail in section 3.4. Factoring, which is largely underutilised as a potential source of finance, is also discussed in section 3.3.

The major problem area in working capital finance appears to be the inability to fund the complete production cycle. It should be possible to finance all costs incurred in delivering against confirmed orders starting from the raw material stages. Interviews indicated a number of firms who were unable to take on additional export sales because they were unable to arrange the finance necessary for the longer production runs. Where the increased export orders result in longer production cycles but do not remove the cyclical nature of the financing need then it is appropriate to increase the overdraft facility.

It is difficult to understand how a bank can justify financing a short inefficient production run and then, because of the size of the loan refuse to finance the more profitable longer production run, caused by the receipt of a firm order. Frequently, however, the real problem is that overdraft is not the most appropriate form of finance. In the event of the expansion resulting in additional permanent financing needs, or if the production cycle is increased to reflect hoped-for, rather than firm orders, then equity or other long term finance is more appropriate.

In conclusion, nearly all short term finance is funded by overdraft. There is almost a complete absence of specific mechanisms for financing stocks and debtors. If instead of providing a single overdraft facility the banks were to provide self-liquidating loans against specific assets a more realistic assessment could be taken about specific business needs. With the devaluation of the security available to the banks under-floating charges because of the increase in the position of preferential creditors, the development of such specific financing mechanisms is important.

### 5.5 Summary

The sources of equity funding for manufacturing industry are very limited. The private investor has not been a significant provider of equity due to the distortions in the risk/reward relationship referred to earlier in the report.

The Stock Exchange has been a source of capital for a very limited number of large companies. This reflects the poor profitability of manufacturing industry and the narrow base of the Stock Exchange which is not representative of the broad range of economic activity in Ireland.

Venture capital companies provide equity in situations where businesses have potential for high growth. In general, the venture capital companies are not investors in start-up manufacturing enterprises. They have a preference for companies with a successful track record. There are, however, only a limited number of such investment opportunities in Ireland and as a result venture capital companies have a surplus of funds for investment. If the recommendations concerning tax write-offs for equity investment are put into place venture capital companies may be more willing to invest in higher risk seed and venture stage manufacturing companies.

It is not constructive to apply capital gains taxes on a company or individual who realises a profit on an investment and immediately re-invests the proceeds. It is suggested that capital gains should only be applied when gains are consumed and not when they are re-invested.

Pension funds and insurance companies are not significant sources of equity or long term finance – in loan form – to manufacturing industry. There is a fear on the part of these funds of being overly exposed to the risks of any single investment, a fear of being unable to liquidate their investments, and a willingness to provide funds only when other pension funds are also investing. There is a need for a vehicle which would pool equity and long term loan investments for pension funds and remove these fears. This could be done in a way which would spread their risk over a wide range of investments and minimise the impact on the individual pension funds or insurance company of the failure of any one investment.

While over 300,000 people are covered by pension funds no attempt is made to make these pension fund holders aware of how their funds are invested. Creating such an awareness may help to develop a greater understanding of the needs and importance of successful performance of industry and the alternate investments.

The expansion in manufacturing industry over the last decade has been funded primarily by IDA grants and bank debt. The banks have not been providers of equity funds to manufacturing industry. In the present environment some bank loans have all the characteristics of

equity but without the returns which accrue to the equity holder.

The introduction of new equity into firms could be encouraged if the IDA were to require all second round grant-aid to be matched by an equal amount of equity in the form of cash investment or surplus (i.e. cash available but not necessary for the successful carrying out of the business) retained earnings.

There are currently three State organisations involved in company rescue – the IDA, Foir Teoranta and the Revenue Commissioners. It is important that these three organisations function in such a way as to ensure the most efficient allocation of State funds.

There is a need to develop a Market/Development Finance Scheme to assist export development. This scheme should provide funds in the form of repayable loans where repayment is made through a percentage annual charge on export sales achieved.

There is a need for banks to develop specific mechanisms for financing stocks and debtors. If banks were to provide self liquidating loans against specific assets, a more realistic assessment could be made of the specific business needs.

A reduction in security as a basis for lending, the provision of loans for product/market development and the development of specific mechanisms to finance stocks and debtors would all be facilitated if banks acquired a much greater level of sectoral expertise.

## CHAPTER 6

### FINANCIAL EXPERTISE

It is essential to examine not only the services and advice being offered by the banks and other suppliers of finance, but also the level of expertise of the companies with which the banks interact. This assessment is primarily oriented towards the financial management area. It is difficult to provide an accurate measure of the quality of management and ultimately one must rely on what may be overly simplistic yardsticks.

As well as examining the quality of management, the interviews looked at the main sources of financial advice used by companies.

Initially we will examine the quality of financial management and subsequently the sources and needs for advice.

#### 6.1 Financial Management

The importance of management expertise is underlined by the perception among institutions that the key factor in the collapse of firms is bad general management. Despite the deterioration across all manufacturing sectors, there was at least one company in each sector which showed significant improvements in both output and profitability. The institutions generally felt it was management quality which allowed these companies to achieve superior performance. The IDA also strongly endorsed the view that bad management was a major factor in causing company collapse. In particular, they quoted examples of companies tendering for, and accepting, contracts which could not be executed at a profit, and examples of companies refusing to take remedial action until it was too late. While the latter problem is unfortunate, the former is more serious as it affects not only the company, but pricing at a loss also damages other members of the industry.

Foir Teoranta are in the process of increasing their after-care service as a means of strengthening the management in their client companies. This suggests that they too have identified management weaknesses as a key concern.

The banks generally perceived some improvement in the companies'

production of financial information both in terms of industrial management accounts and projected cash flows.

The survey indicates that of those companies with more than 200 employees all had full-time financial executives who were qualified accountants or had equivalent financial expertise. These companies produced adequate financial information. Fifty percent of the companies in the survey with less than 200 employees had no qualified financial personnel. The production of internal management accounts varies considerably. Many firms do not produce adequate management accounts and measured profitability solely by the state of their overdraft balance.

A number of companies have absolutely no internal financial expertise and do not seek advice from outside. An example of this is two companies exporting over 50% of sales, but entirely unaware of the existence of foreign exchange forward markets.

The survey indicates that where companies managed their bank relationship, it was a constructive one.

The board of directors is not perceived as a potential source of advice for the smaller company. Most small companies do not have any external directors and do not consider their potential value as a supplement to compensate for internal deficiencies.

Some newly-established firms felt very strongly about the benefits they had derived from the use of an experienced outside Advisor/Director, particularly in dealing with banks, IDA, other State agencies and Government Departments.

It is difficult to know why management is considered bad or to know whether, or if, it is bad in relation to other countries. There is, however, evidence to show that Irish management is younger than in other countries and that, due to the lack of mobility in the Irish market, management experience of different companies, industries and environments tends to be a lot less than in countries such as the US.

We feel that mobility should be encouraged. At present, there are major obstacles to mobility. Two major ones are:

- (i) the lack of transferability of pension fund rights, which effectively deprives people of a portion of their savings;
- (ii) discriminatory employment rules which seek to ensure little mobility between the different employment sectors.

The age and experience problem could be greatly compensated for by encouraging the employment of experienced outside directors. A most valuable reservoir of untapped management talent exists amongst those who have recently retired, having achieved a considerable level of expertise and experience during their careers.

## 6.2 Financial Advice

The survey indicates that the major source of financial advice is internal management. The banks are considered the second most important source of advice, with consultants, auditors and the IDA ranked as third.

A surprising feature of the interviews was that 80% of the companies without qualified financial personnel still relied on internal management as the primary source of financial advice.

While most companies felt that outside advice was useful on some occasions, their overriding feeling was that it was the internal responsibility of management to manage their company, and that even if they were in trouble it was not the role of either the IDA or the banks to sort out their problems.

A recent CTT survey indicated that less than 25% of exporters consider themselves to have in-house expertise in the area of foreign exchange, export credit or credit insurance. The survey underlines this fact. There was a perceived need among companies for advice on export-type financing. Companies would like this advice from CTT as part of an integrated export advisory service but, in general, they did not perceive CTT as capable of providing this financial advice at present.

While there is a clear need for specialist advice, particularly in the finance and marketing areas, there is a reluctance among companies to be hand-held. The IDA is beginning to require that companies obtain specialist advice where they feel deficiencies exist. This is certainly appropriate.

Many small companies perceive their local bank manager as a potential source of advice. These managers may be able to suggest the use of outside advice or consider bringing in the advice at board level.

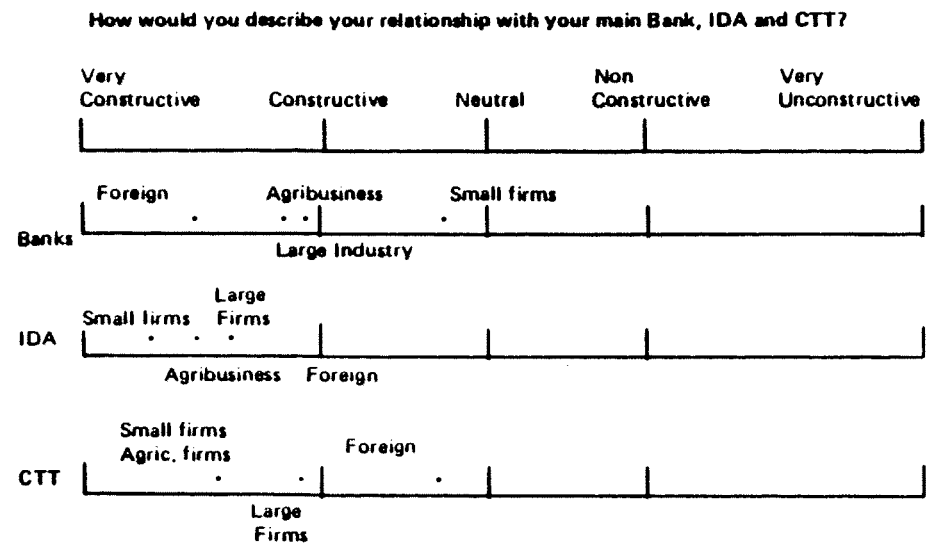
## 6.3 Relationships with Financial Agencies

In the survey the relationship which companies have with their banks, the IDA and CTT was explored. Anticipating that companies of different size and background were likely to have different perceptions of these institutions, the data was analysed on the basis of whether firms were in



agribusiness, were foreign-owned, were small indigenous firms, or large indigenous firms.

The first question asked and a schematic description of the answers is set out below:



Foreign firms, agribusiness and large firms have constructive relationships with their banks. This is consistent with the banks' clear sectoral expertise in agribusiness and with our view that both foreign and larger indigenous firms have few problems in obtaining bank finance. Small firms, on the other hand, have a very neutral view of the relationship with their banks.

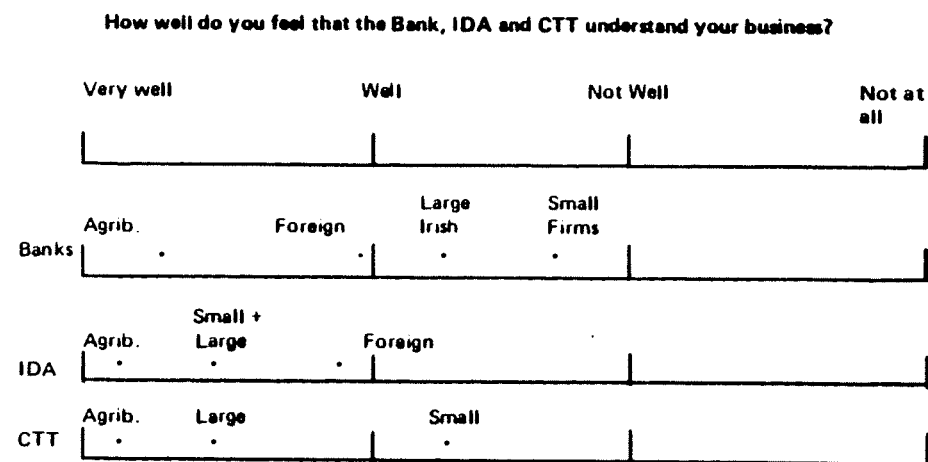
In the case of the IDA it is not surprising to find that small firms which depend heavily on them had the best relationships with them.

Foreign firms have a neutral attitude to CTT, reflecting the fact that they have less use for their services since they are mostly production units with marketing responsibility not being located in Ireland. On average, companies' relationships with the bank, the IDA and CTT must be considered good although there were certain instances where companies found all three non-constructive.

The ICC was not the main bank to any of the companies interviewed. Many deal with the ICC but tended not to have a close relationship and viewed them more as a conduit for EIB money rather than as one of

their banks. However, the ICC's role in providing long term fixed rate EIB money was viewed as very constructive. There was a general perception that, despite the lack of an ongoing relationship between the ICC and the company, the ICC had a better understanding of the business at the time the loan was processed than the people with whom they were liaising in their main bank.

The second question and a schematic description of the answers is set out below:



The clearest result is the very good understanding of the agribusiness area by each of the banks, the IDA and CTT. Even though with both the banks and the IDA the agribusiness area did not come out as showing the most constructive relationship, these companies clearly felt that the banks and the IDA understood their business very well.

Apart from the agribusiness area the ranking in terms of understanding was similar to the ranking of the relationship. Small firms perceived themselves as least understood by the IDA. In the case of CTT, we have ignored the foreign firms as most of them had no relationship with CTT and consequently would not have expected CTT to understand their business. Of those who had contact with CTT small companies felt that they were least understood.

In general, those with an ongoing relationship with CTT are very satisfied (there were some definite exceptions to this), particularly with assistance in appointing agents in overseas markets and in obtaining assistance in overseas markets where CTT is represented. However,

there is confusion as to the precise role of CTT. Many exporters incorrectly perceive them as a grant provider similar to the IDA rather than primarily as an export marketing advisory service.

Because of the very great need for banks to understand the business to which they are lending, especially when one takes into account the very high gearing levels in Irish industry, the frequency of bank personnel visiting the business was explored. The question and the responses are shown below:

Does someone from the bank regularly visit your plant?

	Small firms %	Large firms %	Agric. firms %	Foreign firms %
Never	23	30	13	0
Less than once a year	23	10	0	0
At least once a year	54	60	87	100

Foreign firms without exception were visited by the banks at least once a year. There may be a few reasons for this: firstly, the banks attempting to develop new business, since the foreign firms are in a growth position; secondly, it may reflect an expectation on the part of foreign firms that they be visited by their bankers rather than the converse.

The small firms were least frequently visited, had the worst relationship and felt least understood by the banks.

As previously indicated, nothing in the interviews suggested any difference among the four Associated Banks. Due to the operation of the Bank Cartel the Associated Banks always act in unison and only after agreement has been reached among themselves. This process has resulted in a uniformity of service and a lack of imagination and innovation. Indeed two years after the introduction of short term financing schemes for exports the banks have not yet printed a brochure on the scheme. The pricing of bank services is the same from one bank to the next and the range of services and their quality does not vary from one bank to another.

The loser in this scenario of non-competition is the customer who is likely to choose his banker on a historical or purely geographic basis.

A number of companies interviewed had extremely bad relationships with their banks. This would appear to be due to a lack of understanding by each party of the other's position. The result is a lack of co-

operation which only serves to increase the risk to both company and bank. Where a bank is unwilling to support a company, it should spell out clearly the reasons why it is unwilling to do so. This is particularly so as it is very difficult for companies to move their relationship to a second bank when an existing banker is being unsupportive.

#### 6.4 Summary

There is a wide perception among institutions that a key factor in causing the collapse of firms is bad management. It is difficult to know why management is considered bad or to know if it is bad in relation to other countries. However, there is evidence that many smaller companies do not employ qualified financial personnel. The use of outside advisors is also limited and the Board of Directors is seldom used as a means of obtaining advice and assistance. While companies would welcome assistance they did feel that where difficulties arise that they themselves should sort out their own problems.

The results of the survey indicate that foreign firms, agribusiness and large businesses have the best relationship with the banks. This reflects the frequency with which banks visit the companies. The foreign firms are visited by their bankers at least once a year but 30% of large Irish firms had never been visited. Small firms tend to have the worst relationship with the banks and the best relationship with the IDA. In general, those with an ongoing relationship with CTT are satisfied.

Consistent with the banks' sectoral expertise in agribusiness and the IDA's and CTT's knowledge of their industry, agribusiness firms feel that all three understand their business well.

There is no perceived difference among the four Associated Banks. The lack of competition among the banks reinforces this perception and results in a sameness in the service and product range provided.

Where a bank is unwilling to support a company it should provide a clear reason why it is unwilling to do so.

## CHAPTER 7

### RECOMMENDATIONS

The recommendations are set out in two sections. The first deals with the nine key recommendations of the Report. These recommendations have their primary focus on improvement in the efficiency of the allocation of State and private finance, and the development of a pro-enterprise attitude in the community. The improvement in the allocational efficiency is to be achieved by removing anti-industrial investment biases, by increasing competition at all levels between the financial institutions, by clearly allocating responsibilities between public sector organisations, by linking State grants to company performance, by improving the equity base of industry, and, finally, by promoting a financial restructuring of Irish manufacturing industry.

The second series of recommendations deal with other factors which, while not pivotal to the development of Irish industry, either cause unnecessary difficulties for industry or, alternatively, concern institutions or services whose potential has not been fully realised.

#### 7.1 Key Recommendations

##### 1. REMOVE THE DISTORTIONS IN THE RISK/REWARD RELATIONSHIP SO AS TO ENCOURAGE EQUITY INVESTMENT IN MANUFACTURING

The present investment environment guarantees a high post-tax risk-free return from investing in Government funds, while equity investment in manufacturing industry, which is inherently risky, is at a disadvantage compared with both Government and property investments due to tax biases. If such distortions continue it will never be attractive for the investor to assume the additional risk of putting funds into manufacturing industry.

There are particular advantages to investing in Government Gilts, especially for the high tax payer. By investing in Gilts it is possible to take income in the form of capital gains and avoid all income tax liability on these investments. There are additional advantages from investing in Gilts in relation to the payment of capital acquisitions tax.

There are many biases in favour of property investment, including Section 23 of the 1981 Finance Act, Section 29 of the 1983 Finance Act, special relief on industrial buildings and tax relief on mortgage interest. All biases should be removed as they only serve to redirect funds away from their most productive use. The special position of building societies serves to reinforce this allocational inefficiency.

A strong incentive exists especially for high tax payers to avoid direct investment in manufacturing and instead to invest through pseudo-life insurance funds. While the growth of investment funds is welcome it is irrational to allow a device to continue which confers a tax advantage on these funds and which did not arise as a result of Government policy. The special status of these insurance-linked funds should be removed.

Other distortions arise due to the differing taxation treatment of the various deposit-taking institutions. These institutions should be encouraged to compete not on the basis of taxation distortions but on the basis of the service they provide.

##### 2. PROVIDE A POSITIVE BIAS TOWARDS INVESTMENT IN SEED, VENTURE AND DEVELOPMENT CAPITAL

From the investors' perspective manufacturing has been an unattractive medium for investment due to the low level of profitability and the high level of risk free returns available elsewhere. Because there has been no significant incentive to invest in manufacturing, Irish industry now has an inadequate equity base. Private investment has been replaced by State investment. The onus for developing industry now rests almost entirely with the State in the form of grant aid. Much of this responsibility should be shifted back towards the private investor. There is a need to create an environment, for a period of time, which will result in money flowing into manufacturing or other traded sector firms from the private sector. While this will reduce financial risk, in the long term, investment in manufacturing industry will only continue if it becomes more profitable than it is today.

Irish industry, which is small by international standards, needs additional equity if it is to have sufficient risk capital to undertake the essential product market and export development which is necessary for growth. Other countries, such as the UK and France, have already recognised these needs. Due to the small domestic Irish market and the consequent increased risk from essential export market development, this need for equity capital is much greater in Ireland.

To promote a much closer identification between the general community and industry it is recommended that investors be provided with an incentive to invest in issues of new equity either quoted or unquoted. This should take the form of a write-off against income tax. To encourage large flows into the high risk seed, venture and development stages, write-offs should decline from 100% at the seed capital phase to 50% in the development phase. The recommended maximum allowance for write-offs is £5,000.

In Belgium each individual is allowed to offset against his income an equity investment of up to 10,000 Belgian Francs (about £600) each year in publicly quoted companies in both manufacturing and non-manufacturing. These companies are also provided with tax inducements to raise additional equity. The low level of manufacturing tax in Ireland does not permit such an inducement to be usefully offered here. However, by requiring that IDA grants be matched by equity injections of an equal amount companies are provided with an incentive to raise new equity.

The Business Expansion Scheme in the UK allows write-offs of up to £40,000 for investment in industrial enterprises, including both manufacturing and distribution activities. In principle we do not favour as big a deduction as operates in the UK. The joint objectives are to attract additional equity and to involve as many people as possible. Furthermore, there is evidence that in the UK new equity monies are flowing only towards the more developed, lower risk companies leaving seed capital and venture companies deprived of new equity finance. It is our view that the seed capital is the most important stage. Without this "ideas generation" stage there will be no significant venture or development stages. Our research, however, has indicated a need for additional equity in all but the largest indigenous companies. Clearly if there were not a scaled write-off system, funds would flow to the less risky development companies only, leaving R & D companies starved for capital. As there is adequate equity available for the larger companies these write-offs should not be available for companies with net assets in excess of £10 million.

The result is undoubtedly a scheme which is more difficult to administer, but generally should be more cost effective as it channels monies to the needier sectors. It is expected that, as in the UK, funds will be developed to manage some of these new equity monies.

### 3. BANKS SHOULD TAKE EQUITY IN ENTERPRISE DEVELOPMENT PROGRAMME (EDP) COMPANIES

The Enterprise Development Programme is the IDA's programme for encouraging executives to establish new ventures in high growth, high technology sectors. This programme has been successful in attracting a wide range of projects and in 1983, 45 new ventures will be established. However, the capital structure of these companies is characterised by a low level of equity and high levels of bank debt with a consequent increase in the risk of these companies getting into financial difficulty. Because of the high level of financial risk the potential for growth in the higher technology areas of these businesses is not being achieved. In an effort to service bank debt companies are choosing to minimise investment in research and development and maximising production of lower technology products which have immediate revenue generating capacity.

Some of the banks have been strong supporters of the EDP companies and have provided high risk money in the form of bank loans. It is suggested that both the bank and the borrower would benefit if the high risk quasi equity nature of these loans were recognised by the banks taking equity participation in these companies.

The features of an operational scheme might be as follows:

1. The scheme would operate for a period of two years only. After two years it is hoped that the environment for equity participation in general would be influenced by the implementation of the recommendations contained elsewhere in this report and that adequate equity monies would flow to manufacturing projects from private and corporate investors.
2. The banks would take equity stakes in EDP companies with a limit on their participation to 26%.\* Their maximum equity investment per project would be limited to £500,000.
3. The banks would choose those EDP companies in which they would wish to invest. They could be new ventures which are now being established or EDP companies already in operation.
4. If promoters of EDP projects are to be the beneficiaries of this scheme then it follows that equity participation by banks would only occur when the promoter took the initiative by seeking bank participation. (At present banks are not finding a large demand for equity investment in new ventures.

\*Licenced banks would require Central Bank permission for investments exceeding 20%.

This reflects the absence of new ventures and the need for greater investment at the seed or idea stage.)

The rationale for using the banks as the first stage in the development of the equity base of Irish industry is that the banks have direct contact with all industrial firms and are in the best position to perceive both needs and opportunity. This scheme will encourage banks to develop greater sectoral expertise and, by being more closely involved with these companies, ensure that those who represent the banks with small industry have sufficient expertise to advise both the banks and the company.

In some respects the equity investment by banks would be in part a re-definition of high risk loans in existing EDP companies which already have many of the investment characteristics of equity though none of the potential equity returns. To the extent that the banks are making new equity investments, and not just re-defining existing debt, they would have to reduce overall loan exposure by a multiple of the new equity invested, to reflect the higher risk nature of equity relative to more secure debt.

#### 4 LINK IDA GRANTS TO COMPANY PERFORMANCE AND HAVE AN EQUITY MATCHING REQUIREMENT

The IDA is a major provider of funds to industry. In 1982, £209 million of capital grants was provided. It is essential that these funds be allocated as effectively as possible.

It makes economic sense to favour those companies who perform well – particularly in the export area. Companies should only expect a favourable response to second round grant applications where the company has achieved objectives previously agreed with the IDA. These objectives should not focus entirely on short run goals but should relate to the strategic objectives of the company.

The establishment of mechanisms for evaluating company performance is a difficult one. Different performance criteria/targets are appropriate for different companies at different stages of development and in different industries. However, long term export market development should be a key element in the performance measurement.

Over the planning horizon the criteria must be success at import substitution, at least initially, and export performance for those who have reached an appropriate stage of company development. Ultimately,

grant aiding of companies who are incapable of exporting is nothing more than a subsidy to inefficient sectors or firms.

Where a company's plans include provision for export sales it is appropriate that the Business Development Plan should incorporate a 3-year Export Marketing Plan. This plan should be reviewed by CTT and be supported by CTT grant assistance for the period. CTT should also review feasibility studies where export markets are involved.

There should be a strong inducement for companies to acquire new equity. The earlier recommendations hopefully set a climate which will bring forth the equity. There is some concern that owners of firms are reluctant to introduce new equity when there is ready availability of bank finance and IDA grants. Fixed asset financing is readily available. However, the growth of Irish industry requires a much greater investment in both marketing and product development. These investments are high-risk in nature and should be financed by equity.

Second and subsequent rounds of grant aid should be matched by equity in the form of cash investment or retained earnings which at the time of the award of the grant could be withdrawn from the company in the form of cash dividends. Capitalisation of re-valued fixed assets is not an equity injection. This is consistent with IDA practice at present in relation to foreign companies setting up in Ireland which are required to match IDA grants with an equal amount of equity.

#### 5. ENCOURAGE BANKS TO DEVELOP A MUCH WIDER SECTORAL EXPERTISE THAN THEY HAVE AT PRESENT

There is evidence that banks have considerable expertise in the agricultural sector. Agribusiness firms perceive the banks as understanding their business better than do other manufacturing sectors. Banks are more imaginative in devising schemes for the financing of stocks and general working capital needs in agribusiness. The more a bank knows about a sector the less the risk associated with lending to individual businesses within that sector and the less the bank must emphasise security.

Due to technological change knowledge in the manufacturing sector can quickly become obsolete. The banks should acquire in-depth knowledge of the newer industries as they have done in agribusiness, both to protect themselves while servicing their existing client base and to put themselves in a position to make constructive credit decisions in the newer growth areas. If the banks are to successfully participate in

EDP-type ventures, as is hoped under recommendation 3, they will require greater sectoral expertise to ensure the most rational allocation of their investment. Smaller manufacturing companies need contact not only a Branch Manager but also with a manufacturing specialist within the bank.

It is suggested that all firms in manufacturing irrespective of size should have access to an expert in his industry within the bank. The banks' ability to respond to this recommendation may be limited by existing policies for staff recruitment which are governed by restrictive hiring agreements between the Associated Banks as a group and the Irish Bank Officials Association.

#### 6. PROMOTE COMPETITION IN THE BANKING SYSTEM BY DISMANTLING THE REGULATED BANK CARTEL

The Associated Bank Cartel originated in 1913 with the adoption by the banks of an agreed schedule of deposit interest rates. The effect of the cartel is that the Associated Banks do not compete in the specific areas covered by a set of voluntary agreements. The main areas covered by the agreements are:

- Interest rates on overdrafts, term loans and deposits.
- Fees and charges relating to current accounts.
- Foreign exchange commissions and other fees and commissions.
- Charges for Executor, Trustee and Income Tax services.
- Policies concerning staff.

The cartel no longer covers every aspect of the major activities listed above, and there is vigorous competition in relation to the larger accounts.

Up to the mid-1960s the bank merely advised the Central Bank of impending changes in interest rates, whereas changes are now subject to the prior agreement of the Central Bank.

Central Bank approval is also required in relation to changes in items such as current account charges, fees, commissions and the criteria which must be met by customers to qualify for the "AAA" category interest rates. In summary, what once was a genuine cartel is now a cartel subject to Central Bank influence.

The operation of the cartel decreases the flexibility of the individual banks in competing for resources and in the provision and pricing of services. The operation of a cartel cannot be justified on any economic

grounds. Bank cartels are not perceived as necessary in most other developed countries.

If the banks ceased operating as a cartel the overall level of interest rates prevailing in the economy could still be influenced by the Central Bank (as happens in the UK and US markets) through intervention in the money markets. The absence of a cartel would not significantly influence the overall level of interest rates which are established by external developments and domestic macro-economic forces, particularly the former. However, the rate of interest chargeable to any particular borrower would no longer be set by an agreed matrix but would be arrived at through a process of competitive negotiations. The dismantling of the cartel is unlikely to lead to an increase in the amount of credit available either in aggregate or for specific sectors. As indicated elsewhere, the benefits to manufacturing industry will primarily be improved services, a more innovative approach to lending and a more rapid adjustment to the changing needs of industry.

A sophisticated money market has existed in Dublin for a number of years which by definition determined interest rates. The matrix of cartel interest rates has generally followed the real market forces which existed in the non-cartel Dublin Inter Bank Money Market.

As with lending rates, the interest payable on deposits under £25,000 is set by the cartel with Central Bank agreement. In the absence of an agreed interest rate structure there would be considerable competition for deposits not only among the Associated Banks but also with other deposit-gathering institutions. The main beneficiaries of this would be the ordinary bank depositor, however, ultimately manufacturing industry will be the loser if the banks are unable to compete for funds with other deposit-taking institutions. (Note that the low level of interest paid on deposits by the US commercial banks resulted in the rapid growth of non-bank money market funds and the loss of these funds from under-rewarded bank deposit accounts.) In the US and the UK where strong competition now exists between the main banks, a trend has developed where some banks are paying interest on current accounts or on balances over a certain minimum.

The pricing of bank services would be affected by the removal of the cartel. At present the service costs in the Associated Bank are uniform and can be changed only with the agreement of the Central Bank. In the past the pricing of bank services has not reflected the true cost of providing these services. If competition between the banks is covered it is likely that a more accurate costing of services will result. The reduc-

tion of cross-subsidisation between the different services offered by banks will inevitably mean that some consumers of bank services will pay more and others less. In aggregate, however, greater allocational efficiency will result. The Central Bank should have a greatly reduced role in setting price levels and should not allow its price control function to become a barrier to the more accurate costing of services.

The quality and range of services offered to bank customers should be greatly improved by the removal of the cartel. The current sameness of service which the customer receives from the Associated Banks should disappear in a freely competitive environment. We would expect the banks to become much more innovative and service conscious to the benefit of all customers, including those in manufacturing industry.

#### 7. MAKE CENTRAL BANK RESPONSIBLE FOR REGULATION OF ALL FINANCIAL INTERMEDIARIES

To help ensure that competition between financial institutions is maximised and that distortions in the risk/reward ratio are minimised, all deposit-taking institutions should be regulated by the Central Bank which has authority over the majority of banking institutions. Some notable exceptions are:

(1) The ICC and ACC who report to the Department of Finance and are not subject to the same credit guidelines, capital ratios, etc., which the Central Bank impose on the rest of the banking community. The Department of Finance would have to change its relationship with both the ICC and the ACC. These two banks would have to be regulated by the Central Bank, with the Department of Finance purely acting as the controlling shareholder. This does not imply that the State should not continue to route the low cost European Investment Bank funds which have been very useful to industry through these organisations. The State as the owner of these two banks is providing a subsidy on these loans in the form of exchange rate guarantees, and any return which is earned on these subsidised funds should continue to accrue to the State.

(2) Offshore banks who can lend into Ireland on the basis of an exemption from the Money Lenders Act issued by the Department of Industry, Trade, Commerce and Tourism. They do however require exchange control permission, which is issued by the Central Bank. It could be argued that these offshore banks introduce an element of competition into the system, and we would not disagree with this. However, this competition is confined to the large companies who are already well provided for. To the extent that there are economies of scale in banking

these banks would appear to have an advantage over those foreign banks who have established branches in Ireland.

(3) Trustee Savings Banks who report to the Department of Finance and Building Societies who report to the Department of the Environment. Neither of these groups are lenders to industry. The primary investment of the Trustee Savings Banks and Building Societies are in Government Funds and house mortgages, respectively. These institutions receive special tax treatment which favour them over the suppliers of funds to manufacturing industry.

(4) Other deposit-taking institutions which are not under the control of the Central Bank include the Post Office Savings Bank, Industrial and Provident Societies, Friendly Societies, and Credit Unions.

We recognise that regulation of these institutions by the Central Bank will not of itself necessarily increase the sources of funds available to industry. It will, however, leave all deposit-taking institutions under the regulation of a single authority. This should help to ensure that distortions favouring one deposit-taker over another do not arise again in the future and should promote more even competition between the institutions. This recommendation is made in the context of the need to remove and avoid distortions in the risk/reward ratio, particularly those which channel funds away from industry.

#### 8. ALL FUNDS FOR COMPANIES BEING RESCUED AND RECEIVING RE-FINANCING PACKAGES SHOULD BE CHANNELLED THROUGH FOIR TEORANTA WHO SHOULD BE THE PRIMARY STATE RESCUE VEHICLE.

In recessionary times rescue agencies play a significant role in financing manufacturing industry. Decisions regarding the financing of companies in difficulty involve inevitable trade offs between financial risk and social responsibility, and between the cost of creating a job and the cost of saving a job. It is pointless to create a portfolio of the "living dead". Policies must aim at creating firms, which having been rescued, have reasonable potential and opportunity to grow and develop.

There are two types of company rescue:

1. Takeover Packages.
2. Re-financing Packages.

Company takeovers will normally result in a fundamental change of ownership. Re-financing packages, the majority of cases, occur in all other circumstances.

In organising the State's rescue effort, the motivation must be the optimum allocation of State funds. This responsibility will rest with either the IDA or Foir Teo.

In company takeover situations the IDA should play the lead role. The IDA is best positioned to find suitable candidates, either domestically or from overseas, for this type of company rescue. Although it is unlikely that Foir Teo monies will be required in a takeover situation, occasions do arise where they are called on to assist. It is appropriate for the IDA to keep Foir Teo fully informed from the beginning in all rescue cases of a takeover nature.

In all other cases Foir Teo should play the lead role though we would see the IDA playing a significant role in advising Foir Teo on the appropriateness of rescue in cases involving re-financing packages. It is clear that the IDA will have considerable sectoral knowledge and will be aware of the strategic importance, or lack thereof, of the industry. The IDA will in all probability have had a close relationship with the rescue company over the years and will have an understanding of its ability to compete successfully in its market-place. The IDA input, therefore, to the decision-making process, is most important. However, the final decision should rest with Foir Teo.

There are currently three rescue agencies; two are in the rescue business on a voluntary basis, namely Foir Teo and the IDA, the third is the Revenue Commissioners who are an involuntary participant in rescue activities. In many cases companies seeking rescue assistance have aggregate amounts owing to the Revenue which exceed the combined amounts owing to the IDA and the Banks.

While monies owing to the Revenue provide a short term source of working capital, it also provides management with the soft option of not facing cutbacks when downturns in business require this. This is unhealthy from everybody's point of view. The Revenue find themselves having to choose between collecting monies owed to them, thereby putting companies into liquidation, or holding back and allowing themselves to become a permanent source of finance to ailing firms. This choice is eased by the preferential position of revenue debt.

Many firms seeking rescue have an enormous debt in PAYE and VAT monies which cannot be repaid in the two-year time span sought by the Revenue. Usually an effective rescue is impossible unless some arrangement is made concerning sums due to the Revenue. It is impossible for the Revenue to waive the sums owing due to the precedents which would

be set. Furthermore, where large amounts are due to the Revenue, Foir Teo cannot put an effective rescue in place where large amounts of preferential claims are left in the company.

Foir Teo should take responsibility for paying the sums due to the Revenue, and require rescued companies to repay these to Foir over an extended time period. If this arrangement were to exist on an on-going basis, there could be an incentive for firms to accumulate Revenue debts. Foir Teo might consider limiting its function in taking over Revenue debts to some time period, so that its role is limited to the removal of the existing burden which is an impediment to an effective rescue package.

The bulk of Foir Teo funds to industry are either loans at market rates of interest or preference shares. However, in 1982 interest paid on loans outstanding (after provisions for bad debts) amounted to only 2.8%. Clearly Foir Teo is not earning a commercial return on its loans. In appropriate cases Foir Teo should recognise this reality by providing soft loans to rescue companies in exchange for equity. Foir Teo should take direct equity stakes of up to 26% in companies which come to it for rescue in exchange for whatever amount of loan funds at zero interest rate which may be appropriate to the particular rescue situation.

Such a favourable loan package will provide the rescue company with a much greater chance of survival and development in the medium term. This will give value to Foir's equity holding. In the long run this may prove a more remunerative use of Foir's funds than providing loans at commercial interest rates. Rescue companies will have a greater likelihood of survival due to the lower short-term cost of servicing their finance.

In summary, State funds for rescue should be sourced from a single agency, with the objective of saving only those companies with real development potential. Foir Teo should play the lead in all cases except where takeovers are involved. The IDA has an important advisory role to play in all cases, and the key role in takeovers. In restructuring companies at the rescue stage it should be possible for Foir Teo to take over the Revenue debts and to provide some of the funds interest-free. Foir Teo should receive an equity stake in return for their input.

#### 9. ESTABLISH A MORE AUTONOMOUS IRISH STOCK EXCHANGE

An Irish Stock Exchange Council representing all spheres of investor interest should be set up to oversee the operations of the Irish Stock Exchange.



Membership of this Council should include representatives of the stock-broking community, the merchant banks, pension/insurance funds, the Department of Industry, Trade, Commerce and Tourism, the Central Bank and industry.

The objective is to develop a sense of awareness of the particular needs of the Irish industrial and investment community and to encourage existing members of the Stock Exchange to assume a greater degree of responsibility for organising their own affairs and the development of the Exchange. It is expected that the Stock Exchange will continue to foster and develop its links with the other European Stock Exchanges.

The Dublin Stock Exchange is currently a branch of the London Exchange in exactly the same way as Manchester and Birmingham. Responsibility for the organisation and development of the Irish Exchange rests with the Stock Exchange Council in London. With only one voice out of 46 on the Stock Exchange Council there is little the Dublin Exchange can do to influence its own destiny. Nowhere is this better illustrated than in the current debate on negotiated commissions where it would appear that Dublin stockbrokers will be obliged to abide by the rules of the British Office of Fair Trade. A major advantage for Irish stockbrokers in the association with London is their ability to access the Stock Exchanges' Central Guarantee Fund. This fund protects the Irish and UK stockbroking community in the event of financial default by one of their members.

Since the establishment of the link between the Dublin and London Exchanges only one company – Inish Tech – received a full listing. This resulted in only £500,000 being raised from the non-institutional investors. All of this money went for Venture Capital investment in the US. Aside from full listings three new companies came to the market with a USM listing: Fruit Importers of Ireland (£2 million), Woodchester Investments (£1 million) and Bula Resources (£12 million). A number of oil exploration companies have raised money via Rule 163. The only new manufacturing company to raise money in recent times is Memory Computer who went public via the London Exchange and is now also listed on the Irish USM. Indeed, there is also a growing tendency to by-pass the Dublin Exchange by placing shares directly with the institutions.

In the period 1970-1982, £188 million was raised through the Exchange in the form of rights issues, amounting to an average of £14.5 million per annum. Of this amount, 93 percent was shared among five companies: Bank of Ireland, Allied Irish Banks, Cement Roadstone, Smurfits

and Waterford Glass. In other words, rights issues raised only £1 million per annum over the period for the rest of Irish industry.

In the same period licenced banks lending to industry increased by an average of £100 million per annum. Gilts issued to the non-bank public for the same period amounted to £1.6 billion or £123 million per annum.

The Stock Exchange – Irish Unit has not been a source of capital for Irish industry. It can only be improved by developing a market which recognises the special needs of the Irish economy whose state of development is altogether different to that of the UK economy.

## 7.2 Further Recommendations

### 1. CAPITAL GAINS TAX SHOULD BE APPLIED ONLY TO GAINS WHICH ARE REALISED FOR CONSUMPTION PURPOSES AND NOT ON GAINS WHICH ARE RE-INVESTED

Capital gains should be a tax applied only on gains which are realised for consumption purposes. The application of capital gains at a time when switching from one investment to another:

- (a) reduces the mobility of capital,
- (b) decreases the overall level of private investment; and
- (c) provides no incentive for people to stay committed to industry when liquidating an investment.

Throughout these recommendations every effort has been made to increase the equity base, by providing incentives for people to invest in industry. Roll-over relief would discourage people from reducing their investments, while giving them the opportunity to act rationally as investors, by rebalancing their investment portfolios when prudent to do so.

### 2. CO-OPERATIVES TO RAISE EQUITY VIA ROYALTY TYPE BONDS

The structure of the Co-operatives is such that they cannot raise new equity from other than existing members. The balance of the funding comes from the banking system. There is currently no vehicle or investment medium which allows the pension funds or others to provide money to this key sector of the Irish economy.

If the Co-operatives were to increase their product market development activity and find a need for additional equity type finance then it is possible to provide funds to Co-operatives from non-member investors

which would have most of the characteristics of equity from a financing point of view, while at the same time not affecting the control structure or pricing policy of the Societies.

This could be achieved by designing securities, the return on which would be related to the turnover or volume of output of the Societies. For example: if a Co-operative was attempting to develop a market for its cottage cheese then a security could be designed which would give no dividend if no cottage cheese were sold and an increasing dividend depending on the volume of cheese sold. All payment on the bond would be in the form of dividends and the bonds would be irredeemable.

**3. BANK LOAN REFUSALS SHOULD BE ACCOMPANIED BY:**

- (a) REASONS THE LOAN WAS TURNED DOWN, and
- (b) SUGGESTIONS AS TO WHAT ACTION SHOULD BE TAKEN BY THE COMPANY TO MAKE THE PROPOSITION BANKABLE.

In many cases borrowers do not understand the basis of a bank's decision and, in particular, do not appreciate that the bank's attitude to risk is quite different from a promoter's. There is often the feeling on the part of a potential borrower that the bank does not understand his business. In these circumstances, whether justified or not, the borrower feels that it is easier for a bank to say no than to agree to make the loan. The implementation of our recommendation will have a long-term beneficial effect on the relationship between the banks and industry.

**4. REMOVE THE ANOMALIES WHICH EXIST IN THE APPLICATION OF VAT AT POINT OF ENTRY**

The imposition of VAT at point of entry was an attempt to halt a situation whereby the Irish producer was unfairly discriminated against relative to his foreign competitor. Since its introduction the rules for the charging of VAT at point of entry have been substantially refined so that many of the initial problems and distortions have been overcome. In modifying the rules the overriding objective must be to stop the discrimination against the Irish producer.

Minor anomalies still exist and these should be removed as a matter of urgency.

These anomalies are detailed in Section 3.1.3.

**5. PROVIDE SOME RELAXATION IN THE EXCHANGE CONTROL REGULATIONS AS THEY APPLY TO FOREIGN TRADE**

The Central Bank, in general, plays a constructive role in its implementation of exchange controls. There is, however, a feeling that instead of attempting to reduce the amount of controls, as the Irish pound becomes more mature, the Central Bank is becoming more restrictive.

In addition to the increasing level of paperwork there are also some foreign exchange services which Irish exporters need but which are not currently available. These problems particularly relate to the complete inability to provide any exchange protection at the tendering stage of a contract and the equal inability to provide any form of cover where contracts or payment terms last for more than one year.

**6. PENSION FUND HOLDERS SHOULD BE ENCOURAGED TO IDENTIFY MORE CLOSELY WITH THEIR PENSION FUND INVESTMENTS BY BEING FULLY INFORMED AS TO HOW FUNDS ARE INVESTED**

It is a fundamental tenet of this study that an attitude be created in the community which fosters enterprise and encourages performance. A substantial portion of the population are significant investors through their pension funds.

In most funds, however, there is no identification between the pension fund holder and the investments. This identification could, initially, be encouraged by requiring pension fund trustees to provide a detailed breakdown of investments in the funds and their performance over the period.

At a later stage it may be practicable to provide a system which allows the individual pension fund holder to allocate a portion of his pension fund monies between a limited range of unit funds.

**7. CENTRALISE RESPONSIBILITY FOR EXPORT CREDIT INSURANCE WITH THE DEPARTMENT OF INDUSTRY, TRADE, COMMERCE AND TOURISM**

The Department is, at present, the primary decision maker with respect to all aspects of export insurance. It determines which countries will be covered by insurance, which countries will be removed from the approved list, and it must ultimately pay any claims which arise. The Department is also the beneficiary of all premium income except the management fee now payable to the Insurance Corporation of Ireland for administering the scheme. The Department is also the entity with the most comprehensive knowledge and expertise in export insurance.

The current scheme came into force in August, 1983 and is a major improvement on earlier schemes. Some minor problems still exist (e.g. the requirement of Bills of Exchange in all cases) which need to be ironed out.

At present an exporter wishing to avail of export finance under an export insurance scheme must deal with three institutions, his bank, the ICI and the Department of Industry, Trade, Commerce and Tourism (either directly or indirectly via the ICI). Considerable dissatisfaction has been voiced by users of the export schemes about the bureaucracy and the slowness in obtaining decisions. Instances arise where it has been necessary to deliver goods before a decision is finally received.

The Insurance Corporation plays purely an administrative role on behalf of the Department. The expertise and decision-making all rest within the Department and the system could be greatly improved by centralising the administrative responsibility along with the decision-making role.

## APPENDIX 4

### Selected financial ratios

Category: All sectors. Firms with loans in excess of IRE250,000

Ratio	1978 %	1982 %
NPBT/Sales	4.8	0.4
I/PBIT	0.26	0.85
Total Borrowing/Net Worth	0.59	0.73
Current Assets/Current Liabilities	1.4	1.34
Debtors/Sales	.19	.20
Stocks/Sales	.16	.17
CRS/Sales	.17	.20
Land & Buildings/Fixed Assets	.67	.68
Fixed Assets/Total Assets	.38	.39
Short Term Debt/Long Term Debt	.94	.74

## APPENDIX 5

### Selected financial ratios

Category: All sectors. Firms with loans IRE50,000-250,000

Ratio	1978 %	1982 %
NPBT/Sales	6.0	3.0
I/PBIT	.21	.45
Total Borrowings/Net Worth	.45	.47
Current Assets/Current Liabilities	1.38	1.37
Debtors/Sales	.22	.21
Stocks/Sales	.15	.16
CRS/Sales	.19	.19
Land & Buildings/Fixed Assets	.61	.66
Fixed Assets/Total Assets	.34	.39
Short Term Debt/Long Term Debt	1.22	1.02

## APPENDIX 39

### Period by period returns

Year	Long Gilts	Short Gilts	Property	Shares tax rate	
				0%	60%
1970	.15	.10	.15	-.04	-.07
1971	.23	.17	.17	.17	.13
1972	-.02	.02	.20	.98	.95
1973	-.12	.03	.34	-.19	-.22
1974	-.18	.13	.09	-.43	-.47
1975	.35	.11	-.04	.62	.55
1976	.12	.08	.09	.02	-.04
1977	.60	.30	.27	1.09	1.02
1978	-.05	.02	.38	.27	.23
1979	-.06	.00	.34	-.02	-.07
1980	.21	.23	.31	.12	.07
1981	.01	.05	.24	.04	-.01
1982	.46	.24	.13	-.10	-.16
1983	.19	.06	.07	.77	.70

Source: Property data compiled from Jones Lang Wootton, data on Government Gilts compiled by Goodbody & Wilkinson, industrials equity data compiled from Dudgeon and Co. data. Rates are pre-tax, except for industrial shares which are shown pre- and post-tax. Post-tax rates on investment are calculated assuming a 60% tax on dividends but no capital gains tax.

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