Banc Ceannais na hÉireann
Central Bank of Ireland
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Geoeconomic risks to the outlook: The possible impact of escalating trade tensions, alternative tariff and tax regimes on the Irish economy

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As a small open economy, Ireland has benefitted for many decades from greater global integration involving more seamless cross-border movement of goods, services, people, ideas and capital, and the broad multilateral framework that enables such activity to take place. In recent years, a combination of geopolitical developments – UK leaving EU, US-China trade tensions, Russia's invasion of Ukraine, concerns over supply chain security - have all challenged that multilateral framework and raised the risk of greater geoeconomic fragmentation, reversing the extent of global market integration (Aiyar *et al*, 2023). The varying effects of the Covid-19 pandemic and recent inflationary shocks on countries has also been of influence. In this *Box*, the implications of one of the most substantial risks in this vein to the Irish economy that has emerged are discussed, namely a significant escalation of trade tensions globally and a fundamental reorientation of trade and tax policy in the United States (US).

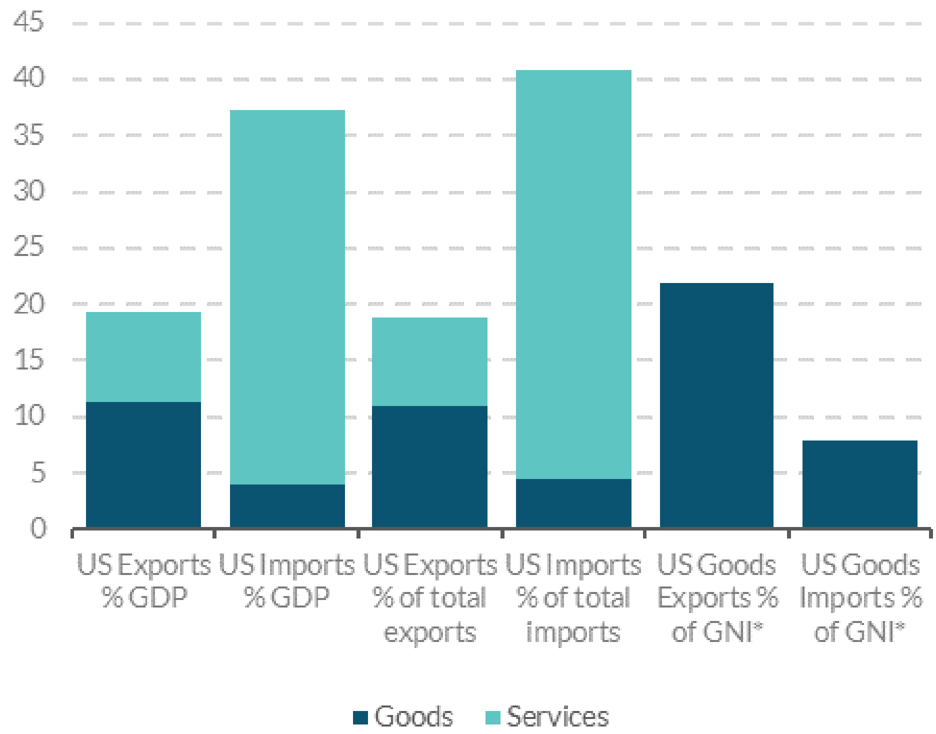
Ireland-US trade and investment linkages

It is useful initially to consider the nature of the economic relationship between Ireland and the US across the interconnected dimensions of trade and investment.[1]

The US is Ireland's largest single bi-lateral trading partner, with total trade values exceeding 50 per cent of Irish GDP (Figure 1). The US accounts for just over 20 per cent of Irish total exports (29 per cent of cross-border goods exports) and just over 40 per cent of Ireland's total imports (16 per cent of cross-border goods imports). Ireland typically has a trade deficit with the US, as imports of services in particular outweighs exports of goods, with the trade balance for the latter product category being positive from an Irish perspective.

Ireland has substantial trade links with the US, with a surplus in goods trade outweighed by a deficit in services trade.

Figure 1
per cent (%)



Source: CSO and Central Bank of Ireland staff calculations.
Notes: Data are for 2022.

[1] With respect to investment this *Box* focusses on US investment in Ireland, and does not discuss in-depth the extent of Irish resident investment in the US, which in 2022 accounted for approximately 25 per cent of Irish resident FDI positions abroad.

This difference across goods and services mainly relates to the nature of production value chains of multi-national enterprises (MNEs) and, in particular, those US companies that have significant parts of their global business resident in Ireland. The majority of Irish imports from the US are intermediate goods and services (66 per cent) and capital goods (27 per cent), with a more even split between intermediates / capital goods and final demand for Irish exports to the US (43 per cent vs. 57 per cent). From an Irish perspective, the large imports of intellectual property and R&D services (Figure 2) enable the production of goods and services by companies resident here, primarily for onward export. This includes categories of goods and services that are exported directly from Ireland to the US, with pharmaceuticals having the largest share of that trade at approximately 45 per cent of Irish exports to the US (Figure 2).[2] It also includes output exported from the State to the rest of the world in pharma, medtech, ICT services and ICT manufacturing that arise from MNEs (mostly US-owned).[3] Finally, the import of services from the US may also be used in the manufacturing and export activity done abroad on behalf of Irish resident MNEs, which currently accounts for14 per cent of Irish exports.[4] Overall, the extent of trade with the US in large part reflects the intra-company import of intellectual property and related services, supporting the production of high value-added pharmaceuticals, ICT services and some ICT manufactured goods in Ireland by those US MNEs in a way which maximises the net profits of those companies., Much of this, in turn, is exported along the same intra-company value chain to both the US and the rest of the world.

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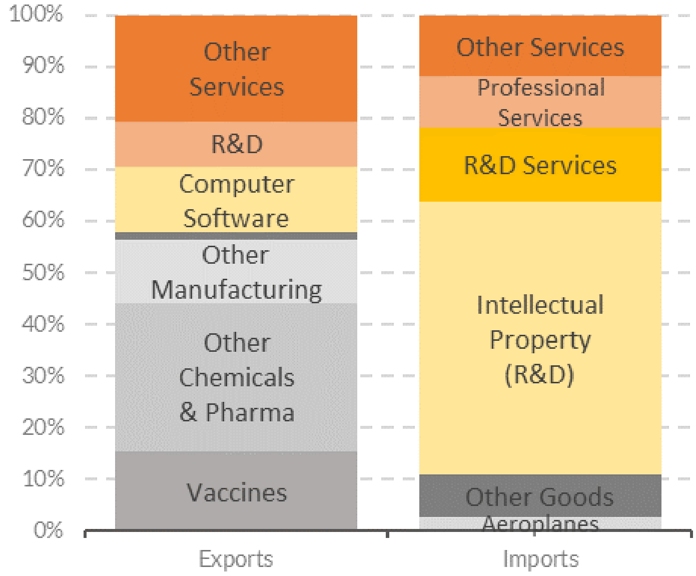
[2] Data from the US International Trade Commission show that imports from Ireland accounted for 2.9 per cent of the volume of pharmaceutical imports in the US in that year, but 24.7 per cent of the value of those imports. This suggests a high value added content and price for the type of pharmaceutical products manufactured in Ireland that are exported to the US.

[3] Some of those exports (imports) are “indirect” trade exposures with the US, as the products concerned may at some point in their production cycle end up in (originate from) the US. For example, Irish chemicals exports to the pharmaceutical industry in the Netherlands may result in exports from the Netherlands to the US. Calculations from global input-output tables (ICIO) suggest that, while these indirect exposures are economically large in their own right, they are small compared to Ireland’s large direct exposures to the US; indirect exports to the US (via one other trading partner) are 6.9 per cent of direct exports, and indirect imports are 4.7 per cent of direct imports.

[4] This is known as goods for processing or contract manufacturing. See https://www.cso.ie/en/media/csoie/methods/internationalaccounts/Contract_Manufacturing_-_rebrand.pdf

The composition of Ireland's trade with the US is driven mainly by production value chains and the related transfer pricing decisions of MNEs.
Figure 2

per cent (%)



Source: CSO and Central Bank of Ireland staff calculations.

Notes: Data are for 2022.

Consequently, Ireland's trade balance with the US and its composition is intrinsically linked to the nature of foreign direct investment (FDI) in Ireland from the US. The US is the largest source of FDI in Ireland (Figure 3). US companies account for 20 per cent of all foreign MNEs active in Ireland, and they are, on average, larger, with higher value-added and greater capital stock, than foreign MNEs whose parent is not US-based. From a labour market perspective, US companies account for almost 10 per cent of business employment in Ireland (35 per cent of all foreign MNE business employment), with these jobs typically being higher paid and mainly arising in the high value-added sectors of pharma, medtech and ICT. The profitability of US MNEs' Irish operations is often not readily available in officially published statistics, but the rate of return on FDI in Ireland is currently averaging around 15 per cent.[5] Given the dominance of US MNEs in FDI in Ireland, this value may be a reasonable estimate of the rate of return those companies in aggregate achieve from their Irish operations. In 2022, approximately 70 per cent of the stock of FDI on an ultimate investor basis was from the US,

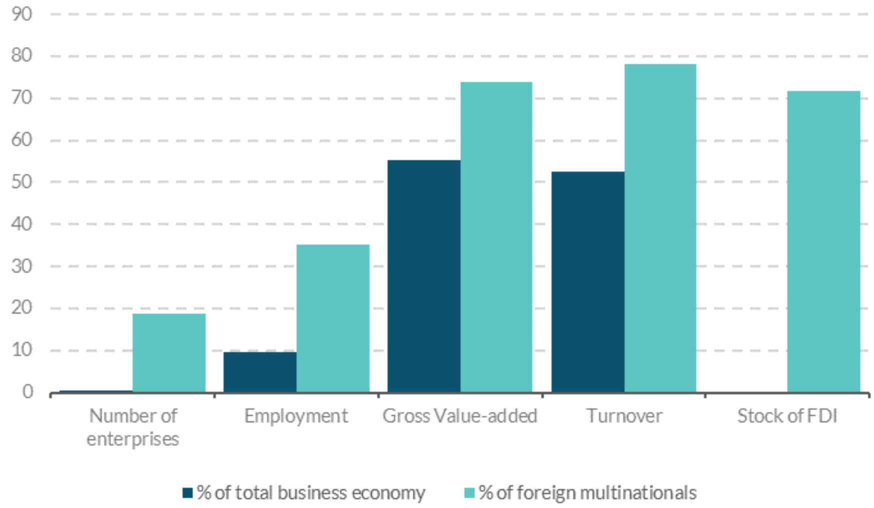
[5] See Figure 4.9 in CSO International Accounts Q2 2024.

and growth in overall FDI has been primarily driven by developments in US FDI over the years.

US MNEs account for a large share of activity, employment and investment in the Irish economy.

Figure 3

per cent (%)



Source: CSO and Central Bank of Ireland staff calculations.

Notes: Data are for 2022.

The profitability of US MNEs in Ireland is a function of several factors: the high value-added sectors in which they operate; the production value chain and related transfer pricing arrangements decided by each company; the labour and other operational costs of physical activity in Ireland; and the tax regimes in the US, Ireland and other countries in which those companies trade. At present, the combination of these factors lead to a significant level of profits being recorded in Ireland, which in turn contributes to the large increases in corporation tax receipts of recent years.

Mapping the transmission channels

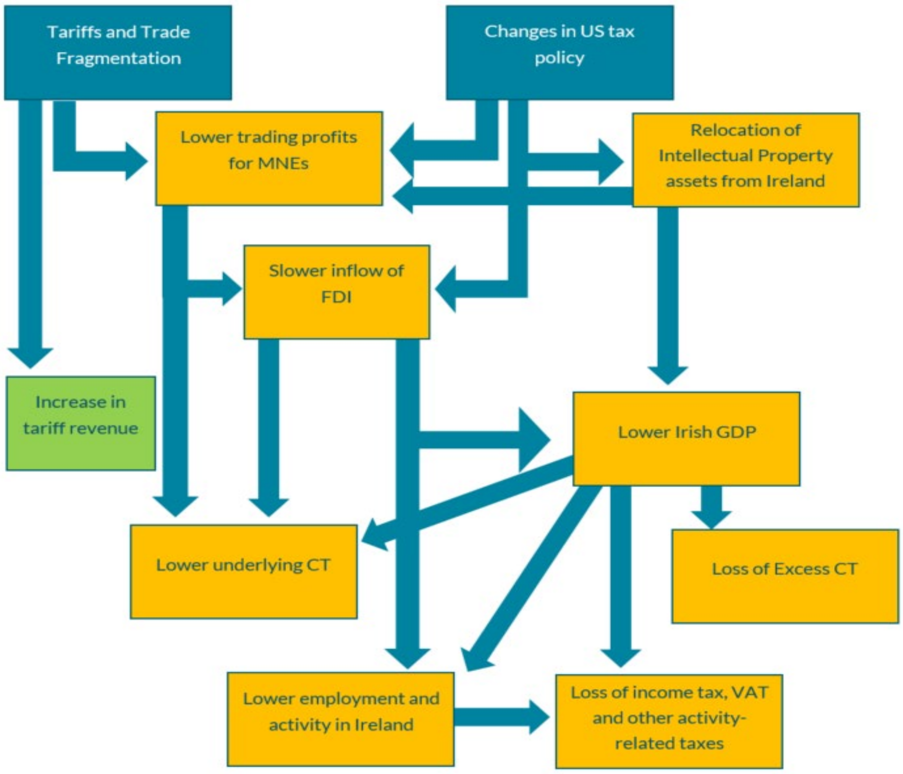
Given the trade and investment links outlined above, it is appropriate to consider how increased global trade tensions and possible changes to trade and tax arrangements in the US could influence the Irish economy. Of particular interest is (1) the possible impact of higher tariffs on goods trade and (2) a lower corporation tax rate in the US or other policy changes that incentivise relatively more capital investment and MNE corporate assets to reside in the US. An illustrative transmission map (Figure 4) outlines the range of possibilities, with the

ultimate outcomes being sensitive to the extent and precise design of any policy changes enacted in the US and how Irish, EU and other authorities respond to any changes in US policy.

Ultimately, higher tariffs or changes in tax regimes that reduce the profitability of operations in Ireland could, to varying degrees, influence future investment decisions by US MNEs here, employment levels in their Irish operations, and the related tax receipts to the Irish exchequer from their activities in Ireland and globally.

US policy increasing tariffs and/or incentivising corporations to declare more of their taxable profit in the US, depending on nature and scale, could influence profitability, activity, employment and tax receipts in Ireland.

Figure 4



Source: Central Bank of Ireland staff.
Notes: The transmission map is for illustrative purposes only and does not indicate any quantification or scale of impact.

Possible implications for the public finances

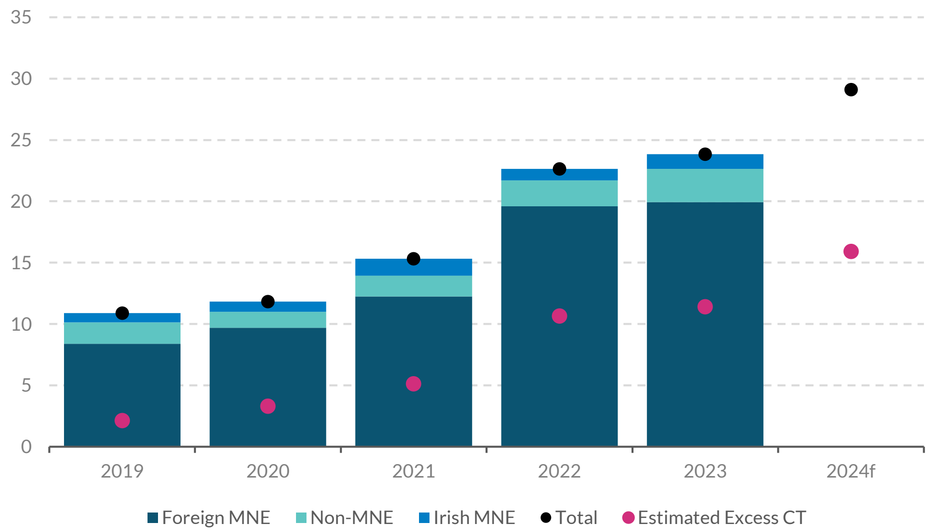
As illustrated above, the transmission of tariff and tax policy shocks to the Irish economy will have resonance for the public finances. Indeed it is likely that the most immediate impact of those shocks would be reflected in the headline public finances, with the more medium-term

drag from the challenging wider macroeconomic situation only becoming apparent subsequently.

A key vulnerability for the Irish public finances is the extent to which the headline and excess, or windfall, levels of corporation tax (CT) that currently arise may be related to the residency of intellectual property (IP) assets in Ireland that were ultimately generated in the US. Growth in these excess CT receipts have driven the overall rise in CT, and have been a significant part of the rise in total tax receipts in recent years. Receipts from CT are predominantly from foreign-owned MNEs, which are likely in most instances to be US-owned (Figure 5). Changes in the US tax regime, whether that be the headline rate or incentives for capital investment or assets to be resident in the US, may change the incentives for US MNEs to retain such IP assets and the related profit in their Irish operation. As discussed further in the *Public Finances* section of this *Bulletin*, absent other policy changes, the loss of excess CT would result in the Irish General Government Balance swinging significantly into deficit from the surplus currently being recorded.

Growth in headline and excess CT receipts sensitive to developments in foreign-owned MNEs, which in turn are dominated by US companies.

Figure 5
€ billion



Source: Revenue Commissioners and Central Bank of Ireland staff estimates.
Notes: Excess CT estimate is the difference between actual (forecast) CT and the average of a range of estimates for underlying CT. The approaches used to estimate excess CT are discussed in more detail here See the Public Finances section of this *Quarterly Bulletin* for the latest estimates of excess CT.

In addition to the potential immediate effect on excess CT, a combination of tariffs and/or changes in corporation tax regimes would likely, over time, lead to lower levels of economic activity generally, as illustrated in the modelling exercise. In the absence of mitigating policy measures, it could be expected that underlying corporation tax receipts, labour taxes and other tax heads such as VAT would be negatively impacted.

Conclusion

The central forecast in this *Bulletin* foresees stable growth in the domestic economy in the near-to-medium term. A key risk to that relatively benign outlook is the possible realisation of geoeconomic risk and, in particular, an increase in global trade tensions or a fundamental change in US trade and tax policy. Uncertainty around potential outcomes is high, and may only gradually become clearer as, and if, specific policy decisions are taken in the US and in other countries.

The profitability of some US MNE Irish operations is likely being influenced by the presence of their IP assets here, which in turn is affected by the corporation tax regimes currently in place. In the near-term, the most immediate effect of a changed corporation tax regime in the US could be a significantly more negative outlook for the public finances in Ireland. An absence of IP assets and related profits in the future may also bring the relative costs of operating in the State along other dimensions into more focus for MNEs (labour, energy, transport, etc.). The impact of such changes could be compounded if the US and other trading partners entered into a tit-for-tat escalation of tariffs.

In other scenarios, however, where cross-border trade becomes less profitable, direct market access through direct investment may become even more attractive, and Ireland may benefit in this respect over the near-to-medium term. Similarly, subject to the degree of tensions between the US and China compared to those between the US and EU, Ireland may benefit in the near-to-medium term from more "friend-shoring" of US investment and trade (Clancy *et al*, 2024). The significant physical investment of US firms in Ireland, particularly in pharmaceuticals, medtech and ICT manufacturing sectors, also presents opportunities to maintain trade and investment connections between the two countries. Nevertheless, the medium-to-long term implications of possible geoeconomic fragmentation, especially as that may alter the relationship between the US and EU, are unlikely to be positive for a small open economy such as Ireland.