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EXPENDITURE CUTS:
THE BELL ALSO TOLLS FOR TAX EXPENDITURES

Dr Micheál L Collins
Department of Economics, TCD
mlcollin@tcd.ie

Mary Walsh
Chartered accountant
walshglencree@gmail.com

Abstract

Tax Expenditures, also known as tax incentives or tax breaks, represent an infrequently explored and little understood area of Irish public policy. Despite this, they account for more than €11 billion per annum in exchequer revenue forgone – equivalent to over 5.5% of GDP and more than one-fifth of total tax revenue (2006 figures).

This paper examines the current tax expenditure regime in Ireland and highlights the role that tax expenditures should play in the Budgetary adjustment planned for later this year and in the years ahead. The paper first reviews the nature and scale of Ireland's tax expenditure system. It then considers their impact, advantages, limitations and consequences. Finally the paper outlines a series of reforms to tax expenditures; reforms which if implemented would yield the exchequer considerable savings in Budget 2011, further savings over the subsequent three Budgets and establish a more appropriate and better administered tax system.

EXPENDITURE CUTS:

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Introduction

Tax expenditures are a formal method for taxpayers, individuals or companies, to reduce their tax liability below that which would otherwise apply. The OECD (2007) defines them as:

> *"a transfer of public resources that is achieved by reducing tax obligations with respect to a benchmark tax, rather than by direct expenditure"*

while Anderson (2008) states that they represent:

> *"provisions of tax law, regulation or practices that reduce or postpone revenue for a comparatively narrow population of taxpayers relative to a benchmark tax"*

Conversely, tax expenditures represent a method for government to reduce its current tax take, perhaps (and ideally) for specified reasons, below what it would otherwise collect. Therefore, a consequence of such policy initiatives is that a tax expenditure requires government to redistribute the burden of taxation across others not availing of that tax expenditure or to decrease the provision of tax funded public services given the tax expenditure induced reduction in the overall tax take.

This paper examines the current tax expenditure regime in Ireland and highlights the role that tax expenditures should play in the Budgetary adjustment planned for later this year and in the years ahead. The paper first reviews the nature and scale of Ireland's tax expenditure system. It then considers their impact, advantages, limitations and consequences. Finally the paper outlines a series of reforms to tax expenditures; reforms which if implemented would yield the exchequer considerable savings in Budget 2011, further savings over the subsequent three Budgets and establish a more appropriate and better administered tax expenditure system.

Tax Expenditures: the Irish Context

In the Irish context, assessments of the costs and socio-economic implications of tax expenditures have, for the most part, represented a little-explored policy wilderness. One reason for this is that the exchequer costs of such measures have essentially been invisible - 'revenue forgone' – and as a consequence often perceived as costless. Furthermore, in the

case of many, if not most, tax expenditures the Revenue Commissioners are not required to collect information on the use and cost of these expenditures while the Department of Finance, in its annual reports, monitor only a handful of high profile, and high cost, tax expenditures. As the 2009 Commission on Taxation report generously concludes: "official publications to date have not comprehensively set out all the tax expenditures in the Irish taxation system" (2009:238).

Overall, limited data and understanding of the nature and extent of the Irish tax expenditure system have impeded detailed examination of these policies by academics, government agencies such as the Comptroller and Auditor General or by various Oireachtas committees.[1] Essentially, discourse in the area has been dominated by demands for introductions, expansions and extensions but with very limited economic evaluation to base those decisions upon. Given this invisibility, the system would seem to have operated throughout the last two decades on the basis of beneficiary induced demand.

The 2009 Commission on Taxation report represents a significant step-forward in our understanding of tax expenditures. It established for the first time a comprehensive list of all the tax reducing measures in the Irish system. This list was then divided into those measures that may reasonably be regarded as part of the normal functioning of the taxation system (the benchmark taxation system) and those measures that are tax expenditures. The latter comprises a total of 131 tax expenditures which we classify into nine groups in Table 1.[2]

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[1] An exception is the tax break on pension contributions which has been examined by NESC (2003) and the ESRI (Callan et al, 2005 and 2009). However, such analysis is principally based on data from national income surveys rather than administrative data associated with the expenditure.

[2] See part 8 of the Commission on Taxation Report 2009 for a description and analysis of each of these tax expenditures.

Table 1 – Distribution of Ireland's Tax Expenditures

	Number of tax expenditures
Children	8
Housing	6
Health	10
Philanthropy	16
Enterprise	28
Employment	28
Savings and investment	8
Age-related and other	7
Property investment	20
Total	**131**

Given the data deficits, a comprehensive assessment of the cost of these expenditures is impossible. However, the Commission on Taxation report does provide estimates for the revenue foregone cost of as many of the individual tax expenditures as it was possible to find. While most of the data is from 2006, some costings are from other years earlier and later in that decade. These figures derive from a number of sources including published data from the Revenue Commissioners, Department of Finance reports and estimates presented to the Oireachtas to accompany the announcement of these schemes, or their extension, in various Finance Bills. In the case of the latter, it is not possible to distinguish between costs derived from detailed empirical analysis and those assembled in a less robust fashion. Table 2 summarises this data.

Table 2 – An Estimate of the Annual Cost of Ireland's Tax Expenditures

	Number of tax expenditure	Number with available costs*	Estimated Cost €m**
Children	8	8	723
Housing	6	6	3,256
Health	10	7	579
Philanthropy	16	7	89
Enterprise	28	12	457
Employment	28	18	2,816
Savings and investment	8	6	2,995
Age-related and other	7	5	144
Property investment	20	20	435[#]
Total	**131**		**11,494**++

Notes: * Data is generally from the 2009 Commission on Taxation Report and part 8 of that report provides more details on the costs for each tax expenditure category. The figures from the Commission's report have been used even though the estimates are based on different years (mainly 2006). Data on property investment is for 2007 from Dáil Question Ref 32811/09

** The category costs are the sum of the costs for those tax expenditures where some costing estimate is available.

Although these schemes have been discontinued, they incur ongoing annual costs as the capital allowances associated with them can be realised against taxable income for a defined number of years. Under current arrangements, costs will continue to arise, though at a reducing rate, for much of this decade.

++ It is important to remember that no cost estimate is available for many tax expenditures and that the quality of the estimation process varies widely.

Unsurprisingly, the largest individual tax expenditures account for most of the exchequer cost. Table 3 profiles the top 10 tax expenditures in the Irish system and reports their individual costs. It also compares these costs versus national income and the total tax take in 2006 (the year of origin for most of the estimates). Overall, the top 10 tax expenditures imply

an annual revenue forgone cost of more than €10b, equivalent to 5.6% of GDP and 17.5% of the total tax-take. Putting the figures in the context of government expenditure in 2006, in that year the current account social welfare budget totalled €12.5b, the current health budget totalled €12.5b and the current education budget totalled €7.2b (Budget 2006).

Table 3 – Annual Cost of the Top 10 Tax Expenditures in Ireland

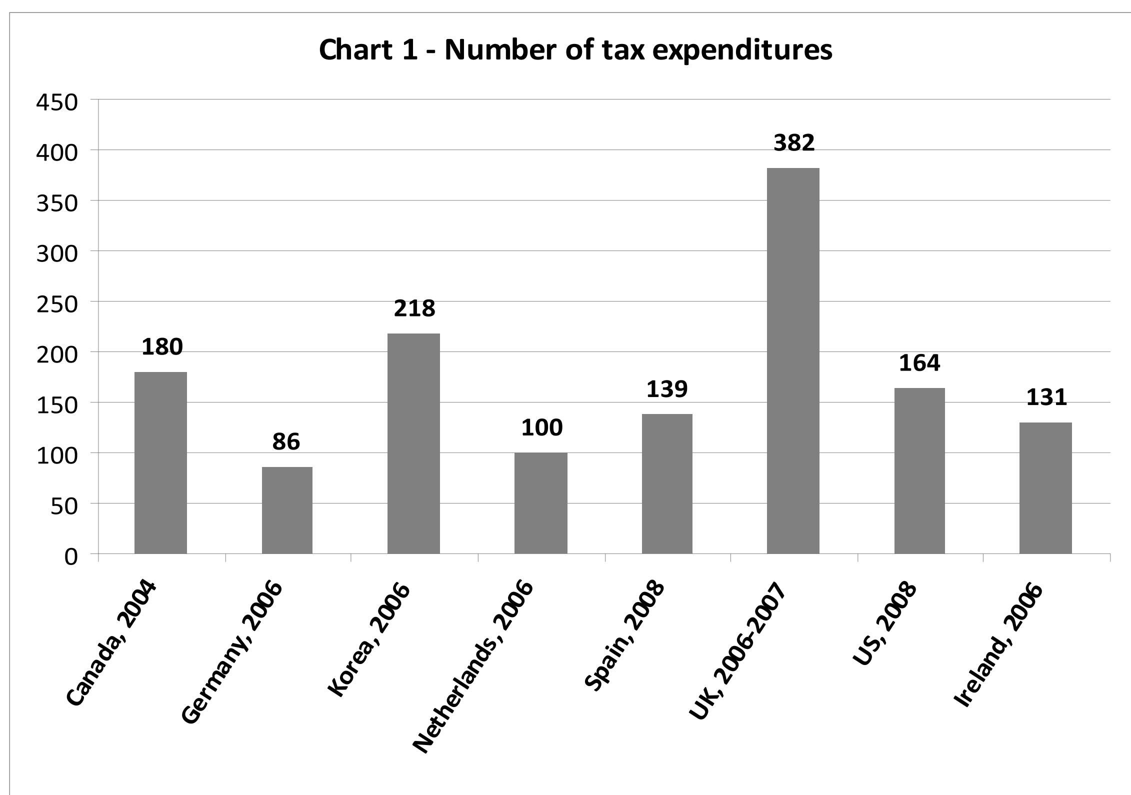
		€m*	% GDP	% Total Tax Take
1	Pension tax reliefs	2,900	1.64	5.09
2	Employee tax credit	2,522	1.42	4.43
3	CGT exemption on principal private residence	2,440	1.38	4.29
4	Mortgage interest relief	705	0.40	1.24
5	Property tax incentives	435	0.25	0.76
6	Child benefit tax exemption	427	0.24	0.75
7	Medical insurance relief	321	0.18	0.56
8	Agricultural relief for CAT	100	0.06	0.18
9	Tax exemption on patent royalties	84	0.05	0.15
10	Stamp duty relief for young trained farmers	71	0.04	0.12
	Total	**10,005**	**5.64**	**17.58**

Notes: National Income data from CSO (2010) and total tax take data from Eurostat (2009). Both are for the year 2006.

* Data is generally from the 2009 Commission on Taxation Report and part 8 of that report provides more details on the costs for each tax expenditure category. The figures from the Commission's report have been used even though the estimates are based on different years (mainly 2006). Data on property investment is for 2007 from Dáil Question Ref 32811/09

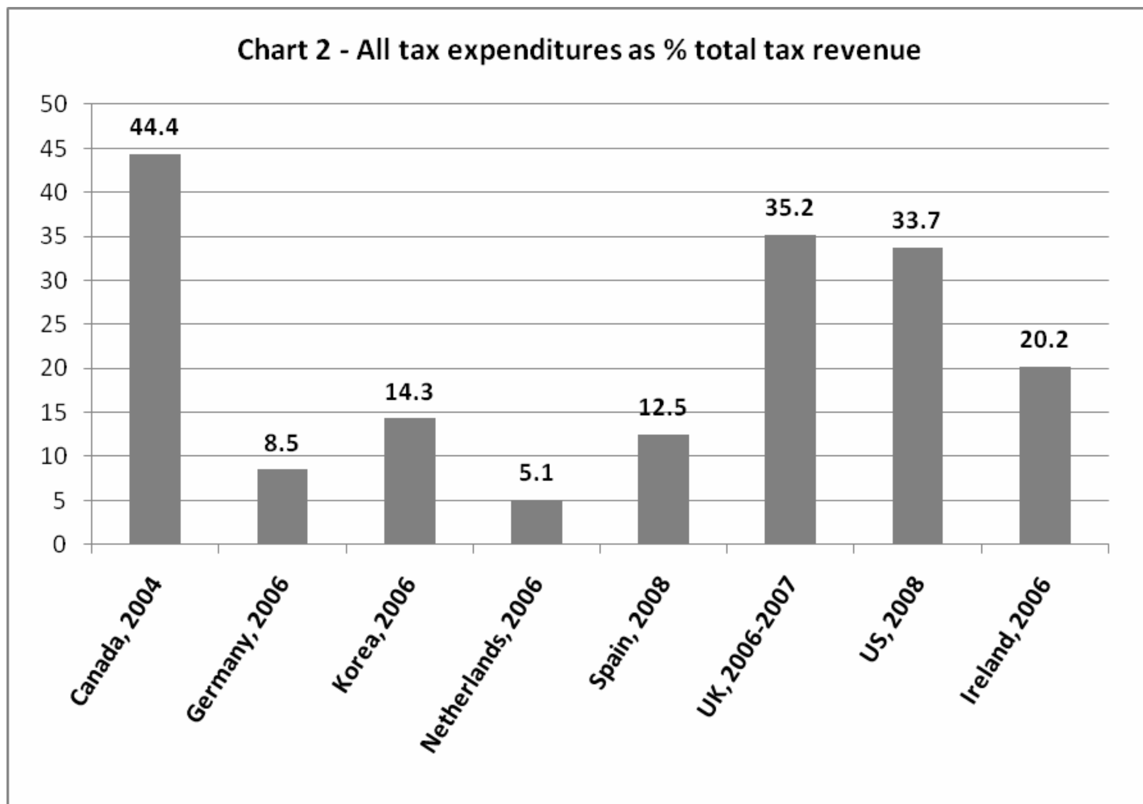
A recent OECD publication, *Tax Expenditures in OECD Countries*, offers the possibility of comparing the aforementioned Irish tax expenditure system with that which they detail in a

selected number of other OECD member countries.[3] Chart 1 compares the overall number of tax expenditures in 7 of the countries featured in that report against the data for Ireland in table 1. Overall, the number of Irish tax expenditures sits midway between the higher levels in the UK, Korea, Canada and the US and lower numbers in continental European countries. Subsequently, chart 2 compares the cost of these tax expenditures versus the total tax take in these countries – the Irish data is calculated using the €11.49 billion estimate in table 2.



Note: Calculated using OECD (2009:233) and data from table 2 above.

[3] The study did not examine Ireland.

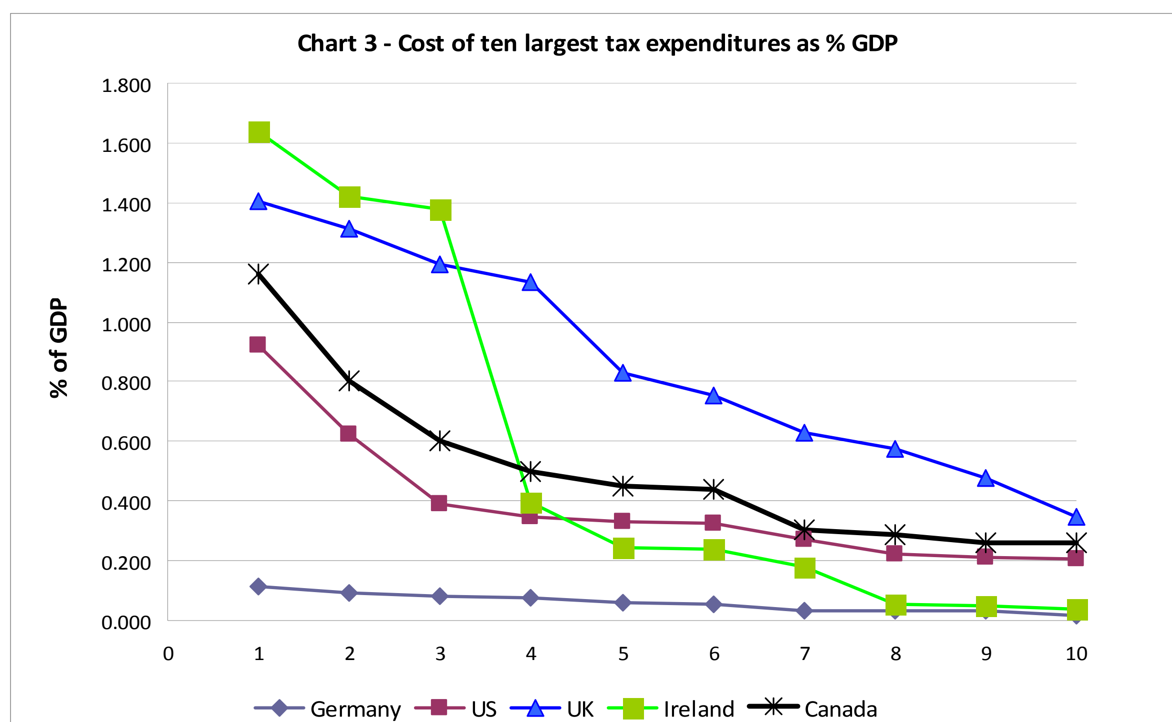


Note: Calculated using OECD (2009:236) and data from table 2 above.

While the number and proportional cost of Ireland's tax expenditures are high, they do not represent an outlier given the data in charts 1 and 2. However, this is not the case when we compare the relative size of the top 10 tax expenditures in Ireland versus that in the six other OECD member countries where disaggregated data is available (OECD, 2009: 237). Table 4 and chart 3 compare the scale of these high revenue forgone tax expenditures and show that in an international context, the cost of Ireland's top three tax expenditures stand out.

Table 4 – Cost of Top 10 Tax Expenditures as % GDP

	Germany	Netherlands	Korea	US	Canada	Ireland	UK
1	0.113	0.248	0.244	0.922	1.160	1.635	1.405
2	0.092	0.207	0.163	0.622	0.805	1.422	1.313
3	0.080	0.123	0.139	0.393	0.600	1.376	1.193
4	0.073	0.119	0.132	0.346	0.497	0.398	1.132
5	0.057	0.101	0.123	0.331	0.448	0.245	0.830
6	0.056	0.073	0.112	0.324	0.438	0.241	0.755
7	0.032	0.067	0.106	0.269	0.306	0.181	0.627
8	0.031	0.054	0.095	0.222	0.290	0.056	0.574
9	0.030	0.046	0.091	0.212	0.259	0.047	0.476
10	0.017	0.044	0.080	0.205	0.258	0.040	0.347
Total	**0.582**	**1.081**	**1.284**	**3.844**	**5.060**	**5.642**	**8.651**



The Impact of Tax Expenditures

The transition in nomenclature over the 25 years between the two most recent Commissions on Taxation from "tax incentives" to "tax expenditures" reflects a closer attention to the real

impact of these measures. However, this is not to imply that tax expenditures should never be used. Few would argue about the effectiveness of export sales relief or the 10% corporation tax rate (due finally to expire on 31 December 2010) in attracting foreign direct investment and in transitioning the Irish economy from agricultural to industrial.

In an ideal and fully integrated world, the role of tax expenditure is to correct market failure and to remunerate merit goods. In the real, and somewhat less integrated, world tax expenditure is also used extensively to attract mobile investment, necessarily from places where it might otherwise locate. Research and development tax credits are an example here. The EU State Aid rules have curtailed the extent to which Member States may use tax expenditures to encourage investment in a particular Member State. Because of this, there is evidence in Ireland of "benchmark adjustment" – if we cannot introduce a tax expenditure, we will change the benchmark tax system so that all taxpayers are eligible for what would otherwise be a tax expenditure. Recent examples include the transition from 10% corporation tax on some activities to 12.5% tax on all activities and the introduction of a participation exemption for capital gains tax available to indigenous and foreign-owned companies.

Comparative advantages of tax expenditure

By comparison with the alternative of direct expenditure, tax expenditure has three advantages:

- It is generally easy to administer and the cost of administration is low. In most cases, the taxpayer claims the appropriate expenditure and obtains tax relief either in a tax assessment (for those making tax returns) or via a refund or a PAYE adjustment. For example, the now-repealed tax expenditure which gave a standard rate credit to taxpayers paying refuse or water charges could be claimed by sending a text message to the Revenue Commissioners. This was undoubtedly easier to administer than a system that required a duplicate reporting system, checked whether a payer of refuse charges was in the tax net and then generated a direct payment. Efficient though the tax expenditure process was, it is hard to see a convincing reason for spending public funds on those payers of refuse charges who happen to be payers of income tax.
- There is a reduced risk of fraud. This is particularly the case for tax expenditure involving parties other than the taxpayer, since fraud then requires collusion. For example, the Irish "tax relief at source" tax expenditures, medical insurance relief and

mortgage interest relief, rely on data from insurance providers and mortgage lenders and thereby provide a third party check on taxpayer claims.

- Tax expenditure facilitates a greater range of taxpayer choices. This is particularly the case for tax expenditures such as pension provision or health expenses, where a broad range of expenses qualify for tax relief and it is left to the taxpayer to determine which type best suits individual circumstances.

Limitations of tax expenditures

Tax expenditures are at best imperfect policy instruments. They suffer from inherent disabilities but more importantly, if they are not appropriately controlled and measured, they lead to systemic degradation of the tax system. Inherent disabilities include:

- Tax expenditures involve a departure from the equity principle and improve the financial position of the beneficiaries of the tax expenditure. Where the tax system is progressive, this involves greater benefits for those with higher incomes.
- Both the efficiency and effectiveness of tax expenditures are difficult to evaluate, in absolute terms and by comparison to an alternative of direct expenditure. This is inherent in having separate measurement and evaluation systems for direct expenditure and tax expenditure. We can argue about the effectiveness of reviews of spending programmes at departmental, C&AG or Public Accounts Committee level but all are likely to be superior to an ex-post review of tax expenditure with poor data, little clarity on objectives and no clear measure of outputs. The inherent difficulty in making a robust measurement of the costs and benefits of tax expenditure has been well summarised as the challenge of counting "might have beans" rather than the normal beans.
- The equivalent of a "demand led" direct expenditure programme is uncapped, non-time-limited tax expenditure. The direct expenditure budgeting process is such that demand-led expenditure can be curtailed with a sunset date. However, most tax expenditures outlive their utility. Whatever policy attractions there were in introducing Urban Renewal Relief in five cities in 1986, it is manifestly clear that property tax incentives cost too much, expanded too widely and lasted too long.
- Tax expenditures and related regulations to control their use range from complex to incomprehensible. The OECD's description is particularly good

> *"Aspects of tax expenditures can cause the resulting complexity of the whole to exceed the sum of the complexity of the parts, in public perception as well as reality. As legal provisions, regulations, instructions and forms are piled upon one another, the body of tax wisdom needed to navigate the system can grow beyond the capacity of many non-experts. The marginal added provisions, even if they do not apply to a particular taxpayer, obscure that taxpayer's field of vision of what he or she needs to know. From a simple systems perspective, the potential interactions among additional tax expenditures could grow geometrically as more are added."*

A prime, though far from unique, example in the current Irish system is the Seed Capital Scheme, designed to refund prior tax paid by unemployed taxpayers to enable them to set up as self-employed, which requires navigation skills to chart 52 pages of complex legislation.

- Other taxes must be increased to finance tax expenditures and thus general tax rates are higher. This may increase the burden of a particular tax (if the compensation is within a particular tax head) or may shift the relative burden of taxes on income, consumption and capital in an inappropriate way. In Ireland, tax expenditures and the interaction between them have been used opportunistically by taxpayers and their advisers, thereby increasing the cost to the exchequer. Property construction, particularly in the hotel sector, has involved the creation of pools of "investors" with substantial income taxable at high rates, whose only function in the investment process was to strip out tax allowances at maximum tax benefit. The return to these participants was largely by way of the tax reduction and the "real" investor, whose tax capacity was smaller, could re-acquire the property at a lower price. This "productisation" of tax expenditures, which is endemic in Ireland, means that the cost of tax expenditure is always maximised.

Systemic consequences of tax expenditures

The impact of escalating tax expenditures on the tax system itself is particularly pernicious. After a half-century of being a poster child for tax expenditure, Ireland is a superb object lesson here. Tax expenditures are concentrated in the income tax system and the systemic impact on the taxation of income is particularly evident.

1. Invention of parallel tax systems to raise revenue

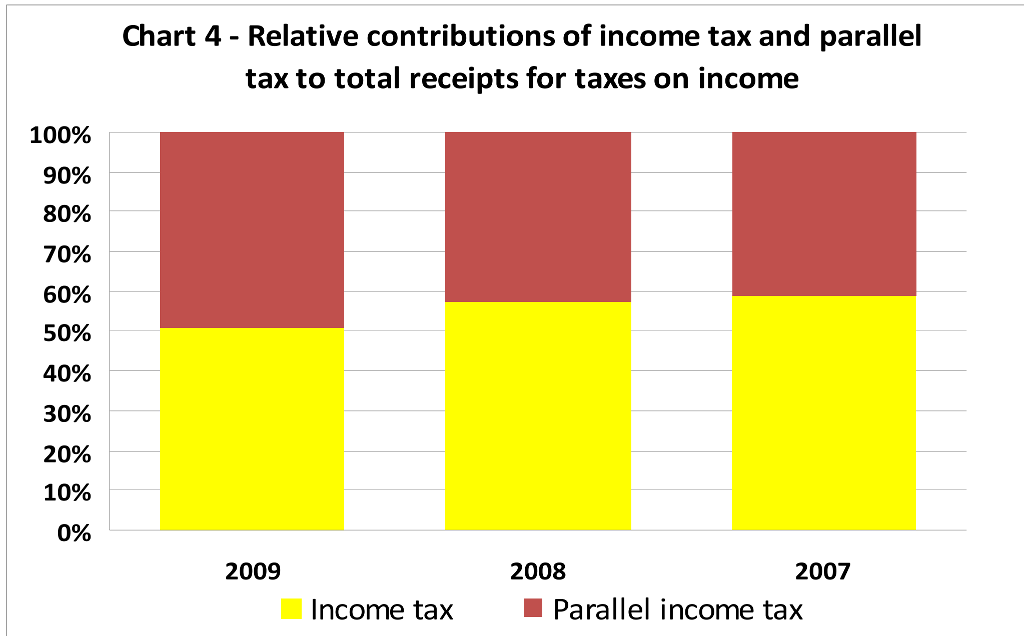
Tax expenditures are so closely interwoven into the income tax system that its effectiveness as a revenue raiser has been significantly impeded. Thus when additional tax revenue is required, the solution is not to raise income tax rates but rather to introduce a series of parallel tax systems with different structures. In Ireland we have not one but four systems to tax income – income tax, PRSI, Health Contributions and Income Levy. Each system comes with its own tax preferences and tax expenditures, but most tax expenditures are in the income tax system. Even the unit of taxation is not common, as income tax is charged on a married couple while the other systems are fully individualised.

As the recession deepened, these parallel tax systems assumed greater importance both as respects their impact on individual taxpayers and also on the relative and absolute quantum of revenue raised. Table 5 shows the aggregate amounts collected for 2007 to 2009 by each system while chart 4 illustrates in relative terms the increasing importance of the parallel tax system.

Table 5 - Tax and parallel tax collections 2007-2009

	2009 **€m**	**2008** **€m**	**2007** **€m**
Income tax	10,701	13,195	13,582
Parallel income tax	10,345	9,708	9,405
Total	**21,046**	**22,903**	**22,987**

Source: Revenue Commissioners' Annual Reports

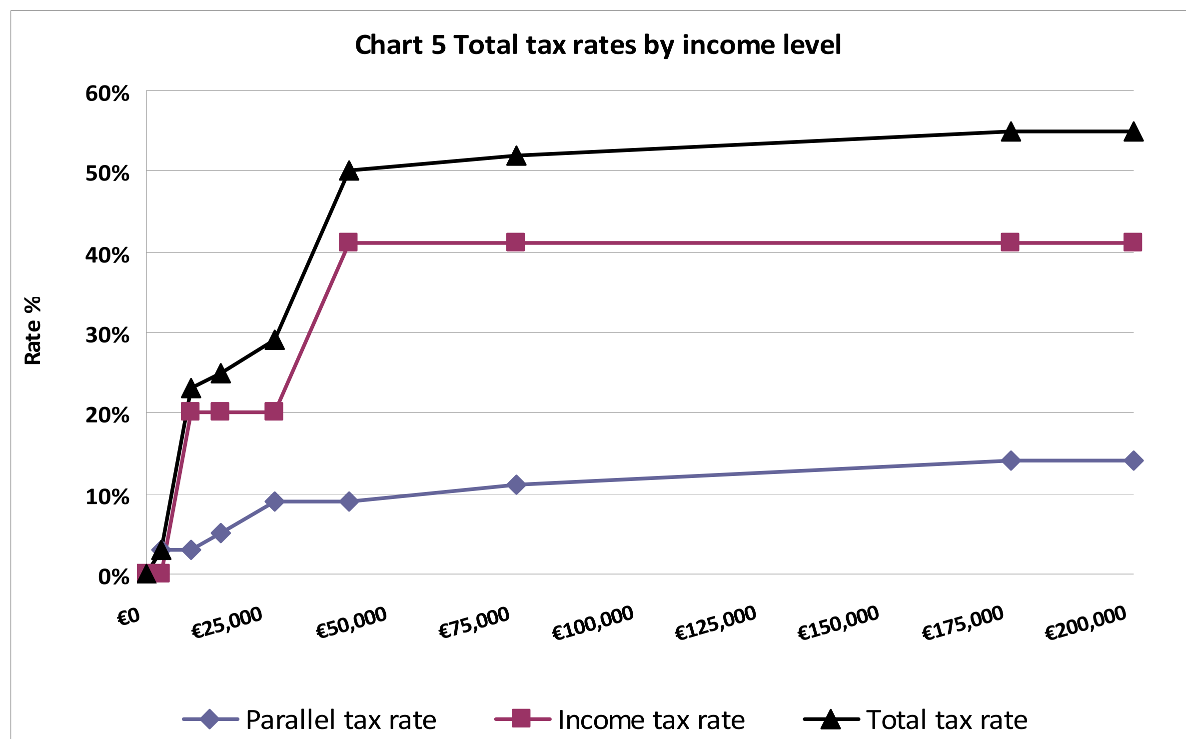


For individual taxpayers, the significance of the parallel tax system (comprising PRSI, Health Contributions and Income Levy) can be clearly seen from Table 6, which shows tax rates for increasing levels of self-employed income earned by an unmarried taxpayer. Chart 5 illustrates the same data for incomes up to €200,000. In most cases, the rates are marginal tax rates. However because the parallel tax system operates by exempting income up to a threshold and charging in full thereafter, actual marginal rates display discontinuities from the figures quoted in a range of incomes close to the exemption thresholds (€3,174 for PRSI, €15,029 for income levy and €26,000 for health contributions).

Table 6 – Tax and parallel tax rates at different income levels for a single self-employed taxpayer in 2010

Annual income level (€)	Parallel tax rate*	Income tax rate	Overall tax rate
Up to 3,134	0%	0%	0%
3,134 to 9,150	3%	0%	3%
9,150 to 15,000	3%	20%	23%
15,000 to 26,000	5%	20%	25%
26,000 to 41,000	9%	20%	29%
41,000 to 75,036	9%	41%	50%
75,036 to 174,980	11%	41%	52%
Over 174,980	14%	41%	55%

Note: * The parallel tax rate captures tax charged by means of PRSI, Health Contributions and the Income Levy.



The equivalent data for an employed taxpayer would show a different pattern because of the impact of the Employee Tax Credit on the incidence of income tax. The equivalent data for a married taxpayer would also show a different pattern because of the different unit of taxation (family rather than individual) for income tax and parallel tax.

2. Complex measures to control the use of tax expenditures by high-income individuals

It might be thought that the obvious way of controlling tax expenditure is to repeal the legislation that provides for the expenditure. Not so in Ireland. Instead, our legislators introduced the principle of (retrospective) moderation in (some but not all) tax expenditures; the Irish version of Alternative Minimum Tax. Not only does this involve complex legislative provisions but, for individual taxpayers, it makes the calculation of the after-tax consequences of investment or enterprise decisions very difficult. A very concentrated summary of the 2010 version of these restrictions might read:

- The relief limits the use of some, but not all, tax expenditures where income, before tax expenditures is more than €125,000.
- There is no restriction if eligible tax expenditures do not exceed €80,000
- Full restriction (to impose an effective tax rate of 30%) applies for incomes in excess of €400,000 and partial restrictions apply for incomes between €125,000 and €400,000.
- Restricted reliefs are carried forward and can offset income tax in future years
- Unlike most elements of the income tax system, the control is individualised and applies separately to husband and wife.

These limits distinguish between high-income individuals and others (companies, low- and middle-income individuals) using tax expenditures to reduce tax liability. For high-income individuals, the controls are applied to a broad range of tax expenditures but there are a number of expenditures that are ignored in applying the restriction. These include tax expenditure on pensions (pension contributions and lump sum payments from a pension scheme on retirement), on termination payments (both statutory and ex gratia), on tax-favoured employer share schemes and on foreign source income qualifying for the remittance basis of taxation where the taxpayer is non-domiciled (individuals resident in Ireland but subject to a special tax regime because they were not born here).

The main impact of these restrictions is to increase the equity of the tax system by increasing effective tax rates of high income taxpayers impacted by the provisions. A 2009 Revenue Commissioners report showed that additional tax of €39m was collected

from 423 individuals impacted by the restrictions in 2008. Table 7 summarises the outcomes of the restrictions for 2008.

Table 7 – Impact of high income restrictions for 2008

Additional tax collected	€39m
Number of taxpayers	423
Effective tax rate (income €500,000 or more)	20%
Effective tax rate (income less than €500,000)	14%
Comparative tax rate without shelters (income €500,000)	39%

Table 8 indicates the remaining benefit of tax shelters for these 423 taxpayers for 2008 after application of the high income restrictions.

Table 8 – Reduction in taxable income of high income taxpayers in 2008 after application of the high income restrictions

Property	€171m
Tax exempt income (artists, patents, stallions)	€72m
Interest expense for equity investment	€29m
Philanthropy	€8m
Business Expansion Scheme	€2m
Expenditure carried forward from 2007	€29m
Total	**€311m**
Maximum tax value (at 41%)	**€127m**

It is clear from the published data that further increasing the tax rate payable under these restrictions would have a marginal impact on exchequer finances, not least because the tax expenditures with the highest cost are claimed by taxpayers that are not impacted by the high income restrictions. However, it would enhance the fairness of the overall taxation system. It is not easy to understand why the list of tax expenditures impacted by the restrictions is less than comprehensive and the fairness of the taxation system would be further enhanced by expanding the scope of the restrictions to cover all tax expenditures, particularly tax expenditure on pensions (pension contributions and lump sum payments from a pension scheme on retirement), on termination payments (both

statutory and ex gratia), on tax-favoured employer share schemes and on foreign source income qualifying for the remittance basis of taxation where the taxpayer is non-domiciled.

3. The impact on tax expenditures when tax rates are increased

Although public expenditure cuts will play a part in restoring fiscal balance in Ireland, it has always been an unavoidable certainty that tax will have to be increased as well. Although new taxes may play a part in this, increasing existing taxes is also an option, and may have more predictable consequences in terms of tax yield.

Increasing tax rates has the inevitable consequence that the cost of any tax expenditure in the system that is based on exempting income or allowing expenditure against income automatically increases. Apart from the equity aspect of this effect, it may also make tax increases even less palatable to the general body of taxpayers that are ineligible for tax expenditures. Thus any programme to increase the overall tax burden must consider limiting tax expenditures as well as introducing new taxes and increasing rates.

Reforming Tax Expenditures

Given that there are 131 tax expenditures in the Irish system, it would be impossible in a short paper to suggest reforms for each of them.[4] Instead, in this section we focus on the top ten tax expenditures and then offer a further series of reforms which are appropriate to some members of that top ten as well as to other existing tax expenditures and the system as a whole. We have provided these recommendations on the basis of what reforms are both necessary and feasible immediately, in Budget 2011, and gradually over the Budgets to 2014.

1. Reforming the top ten

Starting with the tax expenditure with the highest cost, we suggest that the rate at which pension tax relief is granted is moved to a single rate. Such a reform would not only remove a glaring inequity in the taxation system but would simultaneously save the exchequer a considerable sum as the rate would be below the current higher income tax rate. Clearly, there are other, long overdue, reforms needed in the system of pension

[4] Part 8 of the 2009 The Commission on Taxation presents a summary of the Commission's considerations of all these schemes and its recommendations for each of them (2009: 228-323).

provision. These would deserve a paper of their own and have been the subject of extensive and excess examination and consultation. Once government decides what its approach to overall societal pension provision is, then these other reforms should proceed. However, the lack of a definite policy direction in this area should not prevent this initial reform to a single rate of tax relief.

Regarding the Employee tax credit, Mortgage interest relief and Medical insurance relief we believe that there should be a gradual reduction in their value over a series of Budgets such that the latter two are ultimately eliminated while the employee tax credit is noticeably reduced. We explore these proposals further in the next subsection. Similarly, subsection 3 outlines our opinion that some tax expenditures should be limited or the entitlement to relief deferred and we recommend that this is the approach that should be taken to the remaining property tax incentives.

We propose the immediate removal of the child benefit tax exemption such that that income becomes taxable. Given the lack of any adequate integration of the taxation and social welfare system and the regrettable removal of the obligation for PAYE taxpayers to file an annual tax return, such a policy initiative would need to be administered on a self assessed basis for PAYE taxpayers. Child benefit would be paid as normal to parents/guardians, and at the end of the tax year, recipients with taxable income would submit a payment to cover their tax liability. An electronic system to administer this process, along the lines of the NPPR (second homes tax) should be established and the usual random checking associated with the self-assessment system for non-PAYE taxpayers introduced.

We also propose the immediate removal of the tax exemption on patent royalties. The exchequer, through grants and research and development tax credits, already adequately incentivises the development of new products and technologies; indeed this relief has been enhanced significantly in recent Budgets. We think it likely that the patent income exemption has given rise to innovation among tax advisers and patent agents rather than among scientists and inventors. Where patent income arises it should be subject to taxation in the same was as income from any other source.

The two tax expenditures for farming, agricultural relief for CAT and stamp duty relief for young trained farmers have manifestly failed to secure a transfer of land to a younger generation. They are particularly generous given the fall in land values that has occurred in recent years. We therefore propose that they be abolished over a four year period by gradually increasing the taxable amount. Thus the current disregard of 90% of the value of farm land and other agricultural assets could be phased out by reducing the disregard over four years. Similarly the complete stamp duty exemption for land acquired by young trained farmers could be phased out over four years by increasing the taxable consideration by 25% each year.

Finally, we believe that introduction of an annual property tax is a more stable option for the taxation of residential property than abolition of the capital gains tax exemption particularly given the absence of any recognition for inflation/deflation in the capital gains tax system.

Table 9 – Reforming the Top 10 Tax Expenditures in Ireland

	Tax Expenditure	**Proposed Reform**
1	Pension tax reliefs	immediately move to a single rate
2	Employee tax credit	gradual reduction in credit value over four budgets (2011-2014)
3	CGT exemption on principal private residence	introduce annual property tax on residential property
4	Mortgage interest relief	gradual reduction in value over four budgets (2011-2014) so that it is eliminated
5	Property tax incentives	limit or defer
6	Child benefit tax exemption	immediately remove
7	Medical insurance relief	gradual reduction in value over four budgets (2011-2014) so that it is eliminated
8	Agricultural relief for CAT	gradual reduction in value over four budgets (2011-2014) so that it is eliminated
9	Tax exemption on patent royalties	immediately remove
10	Stamp duty relief for young trained farmers	gradual reduction in value over four budgets (2011-2014) so that it is eliminated

2. Reducing tax credit rates

Of the ten largest tax expenditures, three (Employee Tax Credit, mortgage interest relief and medical insurance relief) are given by way of tax credits. These are, in effect, fixed payments to eligible taxpayers and, in the case of mortgage interest relief and medical insurance relief, are available whether the individual with the medical insurance premium or mortgage interest liability is taxpaying or not. While no reduction in tax expenditure is painless to the taxpayer involved, a gradual reduction in the quantum of the credit over time would be an effective way of reducing the cost of these tax expenditures.

Each of these tax expenditures has already successfully transitioned from an allowance at marginal tax rate to a credit at standard tax rate, thereby halving its benefit to higher rate taxpayers. Further progress has been made with mortgage interest relief by reducing the credit rate from the standard rate of 20% to 15% for non-first time buyers.

3. Limiting or deferring tax expenditure

It is often stated that existing tax expenditures must run their course. This is rather like saying that tax rates cannot increase. While investment may have been made by reference to the tax rules in a particular year, it would be disingenuous to think that the fiscal situation in which we now find ourselves cannot be addressed because the Oireachtas is in some moral or legal sense barred from changing legislation on tax rates and tax expenditures. Holding or changing tax rates and tax expenditure amounts remains an annual policy choice.

Such a policy choice has already been made by the introduction of the high income restriction in 2007. The decision to adjust the benchmark tax system by limiting deductible interest expense against rental income to 75% of the expenditure incurred has also been implemented without apparent difficulty. The long-term effects of these changes are different – the high-income restriction permits unused tax expenditures to be carried forward to future years while the interest expense restriction is permanent.

Similar decisions are possible for the entire range of tax expenditures including the remaining property reliefs. Even for such sacred cows as the tax reliefs on pensions, it is entirely possible for the exchequer to take a tax expenditure holiday for the period during which the imbalance in the fiscal position is addressed. Tax expenditures deferred could

either be forfeited or carried forward until the emergence in the medium term of a more balanced budget.

4. Recapturing tax expenditures at higher income levels

The high income restrictions are probably sufficient controls for the tax expenditures that are within their ambit. However a range of other tax expenditures are claimed by a large number of taxpayers with widely varying income levels. Examples would include the Employee Tax Credit, the tax exemption on child benefit payments and relief for health expenses.

An approach that has been followed in other countries is to provide for recapture of tax expenditures at higher income levels. This has the advantage of collecting more tax from those most able to pay while not affecting the marginal tax rate of most taxpayers.

Using the Employee Tax Credit as an example, we can see that abolishing the credit would cause a large number of lower-income taxpayers hitherto not subject to income tax to come within the tax net and would also increase substantially the tax burden on lower to middle income taxpayers. As an alternative to increasing the top rate of tax, we could contemplate recapturing the credit by correspondingly increasing the tax liability of those earning more than, for example, €75,000. This undoubtedly produces a spike in the marginal tax rate for those earning marginally above the limit but has the advantage of retaining the existing marginal tax rates for other affected taxpayers, while increasing their average tax burden. While spikes in the marginal rate at particular levels are not attractive, a spike at €75,000 (or whatever level is chosen) might not be inappropriate until financial circumstances enable a more thorough reform of the tax system to be contemplated.

5. Structural reform of the tax expenditure system

While this paper has concentrated on an exploration and reform of the current system of tax expenditures, there is also merit in highlighting the need for a reform in the way Irish policy making approaches the introduction and supervision of tax expenditures. The first five recommendations from the 2009 Commission on Taxation's review of tax expenditures highlight the approach and components of such a structural reform. These

are reproduced in Box 1 below and we recommend that they underpin all future approaches to tax expenditures in Ireland.

Box 1: First five recommendations on Tax Expenditures from the 2009 Commission on Taxation Report (Part 8)

1 The OECD definition of a tax expenditure - as a transfer of public resources that is achieved by reducing tax obligations with respect to a benchmark tax, rather than by direct expenditure – should be adopted.

2 Measures that are part of the benchmark tax system should not be considered as tax expenditures.

3 In general, direct Exchequer expenditure should be used instead of tax expenditures.

4 There are three instances where it would be appropriate to examine the possibility of introducing a tax expenditure. These are:

- To correct market failure
- To attract mobile investment
- To offset shortcomings in other areas of public policy

Where a tax expenditure is proposed, or an existing expenditure's timescale extended, the following questions should be asked, in sequence:

- does the expenditure fall within one or more of the three instances outlined above?
- If so, does the proposal adhere to each the following principles:
    - Efficiency;
    - Stability; and
    - Simplicity
- If so, can a departure from the equity principle, which the tax expenditure invariably necessitates, be justified?

A tax expenditure should only be introduced, or extended, if it answers affirmatively to each of these questions.

5 For all future tax expenditures and reforms of tax expenditures, there should be:

- *An ex ante evaluation process* in advance of decisions to implement or extend any tax expenditure, including an assessment of the costs and benefits of proposals and consideration of the alternative of a direct expenditure approach.
- *Better measurement and data collection on the costs and benefits* associated with the introduction or extension of the tax expenditure and the review of its impact.
- *Publication of an annual tax expenditures report by the Department of Finance* as part of the annual budget process and subject to Oireachtas scrutiny.

Spending through the tax system should be controlled by, for example, the imposition of thresholds and ceilings and reductions in the rate at which tax relief is given or in the quantum of a base figure to which tax relief might apply.

Source: Commission on Taxation Report (2009:230).

Conclusion

Ireland possesses a large and expensive system of tax expenditures. A total of 131 individual expenditures account for in excess of €11 billion per annum of revenue forgone to the exchequer (see table 2). Despite its size, the tax expenditure system has been subject to limited detailed examination over much of the past two decades; indeed the majority of attention given to the system has been focus on extensions and expansions to existing tax relief schemes, and introductions of new ones, rather than on evaluations of the appropriateness of this forgone exchequer income vis-à-vis its benefits.

This paper provides an overview of the current Irish system and highlights the consequences, intended and unintended, and limitations of the system as it has developed over recent years. We make clear, given the scale of this area of public policy, that things must change. Apart from a structural reform of the way in which tax expenditures are considered and administered, the paper has also shown that reforms of the current system offer the possibility to make very significant contributions to the adjustment process facing the exchequer in the coming months and years.

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