

Tax Incentives/Expenditures and Broadening of the Tax Base

Introduction

1. This paper gives an outline and update of the issues surrounding tax incentive/expenditure schemes and gives information on the actions taken to enable measurement of the estimated costs of certain significant provisions, following on from similar TSG Papers 02/28 and 03/27. It also discusses some options which would have the effect of broadening the tax base.

Background

2. Tax reliefs and incentives take a number of forms and have different, and sometimes numerous, objectives. These objectives include to:
 - Encourage investment in certain activities or geographical areas – such as the Business Expansion Scheme, Film Relief and Urban, Rural and Town Renewal schemes;
 - Reduce the cost of capital and encourage business investment – such as interest relief and various capital allowances;
 - Encourage certain expenditures – such as contributions to pensions and medical insurance;
 - Encourage saving – such as the Special Savings Incentive Accounts;
 - Assist in particular costs incurred by individuals - such as mortgage interest relief and health expenses;
 - Assist certain individuals, or activities – such as the Revenue Job Assist scheme for the long-term unemployed.
3. A table showing significant tax expenditures/incentives is appended to this paper.
4. Tax reliefs and incentives, however desirable, narrow the tax base and therefore must be subject to on-going review. However, the availability of tax reliefs may lead to economic activity that otherwise would not have occurred. Thus, while eliminating a particular relief would lead to direct revenue gains, it also could indirectly lead to revenue losses stemming from reduced revenue from investments, employment, VAT receipts etc. and this could serve to partially or wholly offset the direct revenue gains from eliminating the particular relief. Equally, it has been argued that some tax reliefs are deadweight in that they simply pay companies or individuals for what they do or would do anyway.

5. Economic tax reliefs, when properly focused, are an important tool in the Government's ability to encourage investment in areas of the economy where such investment is needed. Tax reliefs have the advantage over grants in that their impact is determined by success in the market and there is no cost if they are unsuccessful. On the other hand, grants can be readily targeted at those for whom benefit is intended, whereas tax reliefs are available generally and may be used for a purpose much different to that originally desired. It is also easier to monitor a grant based scheme than is the case with a tax relief. In some tax schemes there is a process of certifying particular projects as suitable for tax reliefs on the basis of specific criteria. Such certification procedures apply, for example, in BES and Film Relief.
6. It should be noted that tax reliefs designed to encourage certain investments such as BES, film relief will of their nature have the effect of reducing the tax paid by high earners. Even where tax reliefs are beneficial, their desirability and feasibility must be considered in the context of the general direct tax system applying. For example, sustaining low direct tax rates requires a broad tax base.
7. It should also be recognised that much of the overall cost of these tax expenditures or incentives is accounted for by ordinary business reliefs and by pension reliefs for all employees, employers and self-employed. Such reliefs could not simply be removed without severe consequences for business, employees, employment and future pension costs for the private sector and Government alike.
8. For example, it is normal in business to allow for depreciation as this represents a real cost in the production of goods. For tax purposes normal accounting depreciation is not allowed but instead businesses are allowed capital allowances for plant and machinery. In Ireland these capital allowances provide an eight-year write down period, which would not be considered especially generous from a worldwide or even European perspective in the case of much of the plant and machinery involved especially short-life assets. While this type of capital allowance is classified under tax expenditures it is very much part of any normal system of taxation and should be clearly distinguished from the type of tax expenditures where non-tax public policy objectives are pursued through the tax system.
9. It is also not reasonable to attempt to add up the estimated tax foregone for any particular heading and assume that this would accrue to the Exchequer were certain reliefs to be eliminated. There is little doubt but that, in such a scenario, persons who wish to limit their overall liability to tax will examine their choices with a view to a migration of their investments. Correspondingly, they will almost certainly alter their decisions and this includes taking steps to avail of any remaining tax-based schemes.

Changes to facilitate Information Gathering

10. A constraint in assessing tax expenditures and incentives is the lack of availability in many cases of sufficiently detailed and timely information on costs and take-up. There have been a number of changes made in the past number of years to improve the Department's capacity to examine tax incentive and expenditure schemes. For example, Finance Act 2003 required the return of certain exempt income which was not previously returnable.
11. The Department of Finance and Revenue examined the practicalities of improving data capture via tax return forms. As a result, the Revenue Commissioners have introduced a number of changes to the forms relating to the annual return of income by PAYE and self-employed individuals and companies in respect of 2004 as well as to the P35 form – which is returned to Revenue by employers at end year with totals for earnings and deductions for each employee - in respect of the tax year 2005. The changes to the return of income forms will, over time, yield additional information regarding the cost of various tax reliefs particularly in the area of capital allowances. The P35 return will supply additional data concerning tax relief in relation to pensions.
12. To underpin this work Finance Act 2004 made legislative changes to require an employer to provide the aggregate pension data sought on the P35 form and which will mean that if a taxpayer declines to fill in the additional sections of the return of income form, they will be liable to the usual surcharge and penalties for making an incomplete return.
13. In his 2001 Value for Money Report on the Expenditure Review Initiative, the Comptroller and Auditor General concluded that “operating on the principle of results-based reviews, the scope of the Expenditure Review Initiative should also be broadened to include tax expenditures”. The C&AG followed this up by looking into the question of costing tax reliefs in his Report on the 2002 Appropriation Accounts and, on foot of this, the issue was discussed by the Public Accounts Committee on 22 April 2004.
14. The Department of Finance and the Office of the Revenue Commissioners will be aiming for continuing improvements in this area. In addition to changes in paper-based returns, it is anticipated that IT developments will facilitate information gathering. Recent technology developments in Revenue, particularly electronic filing, using the Revenue On-line System (ROS), are likely to be helpful in this regard. Returns filed in this way can readily accommodate information data capture in relation to tax reliefs being claimed while keeping the extra compliance burden for taxpayers to a minimum.
15. In looking at how information is captured and at how it might be improved, one must always be conscious of the implication of any change for the taxpayer and the effect on Revenue's current strategy to keep compliance costs for taxpayers as low as possible through ongoing simplification of forms, procedures and regulations.

16. In assessing the priorities for information collection the focus is on those tax expenditures for which the availability of cost information would make a contribution to evaluation and policy-making that would justify the additional burden of collecting the information. As well as trying to improve the availability of data on existing schemes, there is an identified need, when introducing new schemes, to bear in mind data capture considerations. For example, the legislative provisions for the new R&D tax credit introduced in Finance Act 2004 require that the credit be identified separately by the claimant.

Evaluation of Tax Expenditures

17. Data on costs is needed to help in assessing and reviewing tax expenditures. The question of how best to evaluate tax incentives or expenditures raises similar issues to those raised in evaluating public expenditure schemes depending on the nature of the scheme and the outputs/outcomes expected. Some schemes readily lend themselves to evaluation where the benefits are clearly identifiable and measurable against the objectives for the scheme. Others are more difficult to assess as the benefits are not easily quantifiable from a cost-benefit perspective.
18. For example, tax relief for expenditure on heritage houses has tourism and heritage policy objectives as would a grant scheme for such houses. Accordingly there may be some quantifiable indicators such as tourist numbers etc. but much of the assessment in both cases have to rely on more qualitative indicators. However, broadly the same criteria of efficiency and effectiveness should apply when measuring tax expenditures as public expenditure items and indeed in assessing whether tax instruments or public expenditure or other policy instruments are the most appropriate in achieving the policy objective. Of course there is also one specific aspect of tax reliefs in that it often seems that the taxpayer's mindset is such that the fact of reducing the tax payable seems more attractive than just the financial or economic benefit.
19. Tax-based schemes are kept under constant review, especially in the context of the annual Budget and Finance Bill process, to ensure they continue to meet the purpose or purposes for which they were introduced. Detailed reviews of the costs and benefits of various tax reliefs are also carried out from time to time. Examples are the Urban Renewal Scheme, the film relief scheme, the seed capital scheme and the Business Expansion scheme.
20. As our data on costs improve we intend to develop and improve our analysis accordingly. However, at the end of the day, it must be recognised that many decisions in these areas come down to a policy call at a practical level. More accurate data will improve the basis for making these judgements.

Base-broadening Measures

21. There have been several base-broadening measures and numerous anti-avoidance measures introduced over the past number of years. All Finance Bills from 1998 to 2004 included anti-avoidance measures. In addition several tax reliefs terminated during this period in respect of new expenditures, including the Seaside Resorts Scheme, the Custom House Docks Area Scheme, the Temple Bar Scheme and the Special Foreign Earnings income tax relief.
22. The major base-broadening/anti-avoidance measures were the following:
- a €31,750 annual cap on the amount of capital allowances on buildings that an individual passive investor can set against employment income or other non-rental income;
 - In the case of hotels, ring-fencing of the capital allowances to rental income in the case of passive individual investors except for certain hotels in 7 N.W. counties;
 - Disallowing the offset of losses and capital allowances of a partnership against the non-partnership income of passive partners;
 - A similar disallowance in the case of passive individual investors in various activities;
 - Abolition of the tax credit on dividends paid to shareholders and introduction of a withholding tax on these dividends;
 - Widening of the CGT base through the abolition of indexation relief (going forward) and roll-over relief; and
 - Application of PAYE and PRSI to Benefits-in-Kind.
23. In addition, almost all of the property-based tax reliefs, which represent a considerable element of the tax incentive structure, have termination dates set into legislation (see below); many of these were extended or amended in Finance Act 2004 in order to provide for an orderly wind-down for the reliefs. In their recent Budget 2005 submission IBEC have argued strongly that there should, under no circumstances, be any further extension of these time limits.

Scheme	Termination Date
Urban Renewal Scheme	31 July 2006
Multi-storey Car Parks Scheme	31 July 2006
Student Accommodation Scheme	31 July 2006
Buildings used for Third Level Purposes	31 July 2006
Hotels and Holiday Camps Capital Allowances	31 July 2006
Holiday Cottages Capital Allowances	31 July 2006
Rural Renewal Scheme	31 July 2006
Park and Ride Scheme	31 July 2006
Town Renewal Scheme	31 July 2006
Living Over the Shop Scheme	31 July 2006

24. The property-based schemes that do not presently have termination dates set into legislation are those for Nursing Homes, Private Convalescent Facilities, Private Hospitals, Sports Injury Clinics and Childcare Facilities.

The Continuing Need for Review

25. The Sustaining Progress Agreement states:

“Tax expenditures will be kept under review and will be amended or terminated if necessary in the light of changing economic and social priorities. Government is committed during the lifetime of this Agreement to ongoing review of the scope for widening the tax base, subject to the key national economic, social and environmental principles identified”.

26. In the context of Budget and Finance Bill 2005 the Department will again be reviewing tax expenditures and reliefs. As well as considering the case for continuing or terminating certain tax expenditures, options for limiting benefits, where appropriate, will also be considered. Some of these options, for example standard-rating all reliefs, as has been sought by CORI in their 2005 Pre-Budget submission, could impact on the attractiveness of tax-based measures and would thus affect the economic and/or social objectives being targeted by the measure. The TSG may wish to consider the list of major tax expenditures and incentives attached in this context.
27. Some new reliefs have been introduced in the recent past, for example the R&D tax credit was brought in by Finance Act 2004 and has been generally welcomed especially given the need for a strategic response to competitiveness pressures created by higher wage costs and the concomitant need to move higher on the value chain. However, given likely spending pressures and the fundamental policy position of maintaining low tax rates together with a broad tax base, any such new reliefs should be continue to be specifically targeted and their impact and effectiveness closely monitored.

Survey of High Earners 2004

28. In 1997, 2002 and again this year, the Revenue Commissioners carried out studies on the Effective Tax Rates for High Earning Individuals based on the tax years 1993/1994 and 1994/1995 (1997), 1999/2000 (2002) and the short tax year 2001 (2004). The 1997 and 2002 studies were placed in the Oireachtas Library. The 2004 study is in the process of being finalised. Preliminary information examination indicates the following for the top 400 earners' cases examined for the year 2001, compared to the 2002 exercise (1999/2000 tax year):

Top 400 Earners distribution in ranges of Effective Tax Rates: 2001 and 1999/00

Range of Effective Tax Rates	Numbers		Percentage of Total	
	2001	1999/2000	2001	1999/2000
%				
Less than 5	35	51	8.75	12.80
5 – 9	15	12	3.75	3.00
10 – 14	8	10	2.00	2.50
15 – 19	18	12	4.50	3.00
20 – 24	20	19	5.00	4.75
25 – 29	19	13	4.75	3.25
30 – 34	56	34	14.00	8.50
35 – 39	110	76	27.50	19.00
40 – 42	119	-	29.75	-
40 – 44	-	121	-	30.25
45 – 49	-	52	-	13.00
Total	400	400	100.00	100.00

29. The above table gives the distribution of high earners for the tax year 1999/2000 and the 'short' tax year 2001. The ranges have had to be altered slightly as the marginal income tax rates applicable reduced over that time.
30. The main changes between 1999/2000 and 2001 are that the number of high earning taxpayers with an effective tax rate of less than 15% has reduced by 3.5% whilst those with an effective tax rate between 15% and 29% has increased by 3.25%. This shows there has been a migration upwards of those availing of low effective rates, as measures such as the capping of capital allowances available to passive investors took hold. The proportion paying at an effective tax rate in excess of 30% also increased slightly from 70% to 71%. This upwards migration took place despite the 2% reduction in the standard and marginal income tax rates in 2001 (from 22% to 20% and from 44% to 42% respectively).

The introduction of a minimum tax for high earners

31. If it is considered undesirable that any high earning individual should be able to reduce his or her tax bill to very low levels, or indeed zero, then one possible option would be to introduce a minimum income tax. This option was considered at the time of the 1997 High Earners Report but the conclusion was that the problem would not justify such a global approach and that such an

approach would be likely to encourage tax planning rather than discourage it. Such a minimum tax could only apply to those on high incomes (e.g. €100,000) and would probably have to be set in the 10% - 20% range.

32. The advantages of such a tax would be:
 - It would help to ensure that everyone would pay a reasonable amount of tax;
 - It would not interfere unduly with the tax incentive schemes provided the rate of tax is carefully chosen;
33. The disadvantages would be:
 - Implementation would require a very complex piece of legislation and decisions would have to be taken as to what should be included in total income for the purposes of this new tax. For example, income could include all profit before losses, capital allowances, pension payments etc. were taken into account. Alternatively, some or all of these items might be allowed before the total income for this tax purposes was calculated;
 - It is not clear how losses or normal business expenses should properly be treated;
 - It is likely that some would claim that the proposal was sanctioning e.g. 20% as an acceptable tax rate for the rich. This would be contrasted sharply with a 42% marginal tax rate for those paying at the marginal rate at relatively modest incomes;
 - By setting a minimum “acceptable” tax rate, some who now pay a higher rate might see such a rate as a target to be attained and reduce their tax payments to this target level.
34. In view of the results of the 2002 and 2004 surveys, the final disadvantage would seem to be the decisive one. 81% of the high earning individuals on whom information is available for the year 2001 are already paying at a rate higher than 20%. If a minimum income tax were introduced, this group of taxpayers would be likely to request their accountants to take steps to reduce their tax bills towards the minimum. Thus, such a tax would be likely to increase tax planning rather than reduce it.
35. Therefore, it may not be prudent to introduce a minimum tax rate, given:
 - the results of the 2004 survey which indicates that the effective tax rate of high earners has increased since the last survey was carried out in 2002;
 - steps as mentioned above have been taken to further limit the opportunities for high earners to reduce their taxable income to very low levels;
 - the problem may not be sufficiently widespread to justify such a global approach; and,
 - such an approach would be likely to encourage tax planning rather than discourage it by drawing the attention of those who are currently not involved to the extent of the involvement of others.
36. In this context it is worth noting that recent reports have raised further doubts about the effectiveness of the ‘Alternative Minimum Tax (AMT)’ introduced in the United States in 1969 to sweep more wealthy people into the tax net,

given that figures contained in the Spring 2003 IRS income statistics bulletin revealed that the proportion of federal income tax paid by the top 400 earners in the US has fallen. The average rate was equivalent to 22.3% in 2000 down from 26.4% in 1992 and 29.9% in 1995.

37. An alternative approach to a minimum tax rate might be to consider similar measures to the limits introduced by the Minister in the 1998 Budget where reliefs are cumulated.

Introduction of a property tax

38. In considering broadening the tax base, another aspect is whether there are areas taxed in many countries, but not taxed here. One such area is residential property. The Department of Finance prepared a detailed paper in 1994 on possible policy directions in relation to the taxation of residential property (Residential property tax was in existence at that stage). Two of the options examined at that time were a tax of 1% of the capital value charged on all households with income above income tax exempt limits and a new property tax based on imputed income.
39. Ireland has one of the highest home ownership rates in the world at about 77%. A property tax could be based on house prices, imputed income or floor area. Any floor area proposal could be open to charges of being anti-rural. One based on market value would be likely to be categorized as a “city” or “Dublin” tax. With regard to a property tax on house prices or imputed income, in 1997 it was estimated that a 1% charge on the capital value or an income tax charge based on an imputed income of 3% of the capital value would raise approximately €304m - €342m (allowing for exemption for those on social welfare). It was noted at the time that the estimated yield would be significantly eroded if the tax were adapted to exclude low income householders, or to reduce the payment where there were dependants or if an allowance were made for mortgages in calculating the tax. Given the more than doubling of house prices since 1997, clearly the potential yield now would be substantially greater.
40. While there may be some economic or even general fiscal policy reasons for introducing property taxes, these could still result in adverse economic effects which could lead to a distortion of the housing market. This would have to be considered carefully in the context of the issues discussed in the TSG paper on Housing Taxation Policy (TSG 04/10). The issue also needs to be considered generally in the context of the acceptability of such taxes. Therefore, any such proposal would need careful consideration before any decision was taken.

Views of the TSG

41. The TSG may wish to consider the various issues raised.

Major Tax Incentives/Expenditures

	<i>Numbers benefiting</i>	<i>Estimated Cost (€ million)</i>	<i>Year of costing</i>	<i>Notes</i>
<u>Corporate</u>				
Capital Allowances (includes business allowances and allowances to incentivise certain behaviour such as urban and rural renewal)	269,300	1,921	2001	(1) (5)
Group Relief	1,500	289	2001	(1)
Resort Relief	n/a	106	2000	(2)
<u>Pensions/Savings</u>				
Exemption of the Income of Approved Superannuation Funds (Net of Pension Payments)	n/a	1,268 *	2001	(1) (6)
Employers' Contributions to Approved Superannuation Schemes	n/a	673 *	2001	(1)
Employees' Contributions to Approved Superannuation Schemes	670,500	526 *	2001	(1)
Special Savings Investment Accounts	1,113,880	540	2004	(3) (7)
Retirement Annuity Premiums by Self-Employed	109,600	170	2001	(1)
Pension Lump Sums	n/a	141 *	2001	(1) (8)
Exemption of Interest on Savings Certificates, National Instalment-Savings and Index-Linked Savings Bonds	n/a	108	2002	
<u>Personal</u>				
Child Benefit - exemption from income tax	348,300	343 *	2004	(4)
Loans relating to principal private residence - interest relief	622,500	221	2003	
Relief in respect of Medical Insurance Premiums	533,800	191	2003	
Expenses allowable to Employees under Schedule E (work related)	855,800	73	2001	(1)
Health Expenses Relief	105,600	49	2001	(1)
Rented Residential Accommodation	n/a	27 *	2001	(1)
Investment in Corporate Trades (BES)	2,015	20	2001	(1)
Investment in Films	1,470	15	2001	(1) (9)
<u>Capital Taxes</u>				
Principal Private Residence - CGT exemption	n/a	1,173	2003	(10)
Stamp Duty Relief for new homes	n/a	294	2003	
Exemption from CGT on occasion of Death	n/a	40	2003	
<u>Indirect Tax</u>				
Disabled Drivers and Disabled Passengers Tax Concessions	7,750	36	2003	(11)
Farm Buildings and Land (VAT Refund)	n/a	33	2003	
Excise relief for local public transport vehicles	n/a	24	2003	
<u>Other Income Tax</u>				
Exemption of income of Charities, Colleges, Hospitals, Schools, Friendly Societies etc.	n/a	11	2001	(1) (12)
Artists Relief	1,300	32	2001	(1)
Donations to Charitable Organisations	29,600	21	2003	
Relief under Profit Sharing Schemes	44,500	35 *	2002	

Notes on Table

Figures accompanied by an asterisk (*) are particularly tentative and are likely to be subject to a considerable margin of error.

- (1) 2001 was the 'short tax year' and ran from 6 April 2001 until 31 December 2001 inclusive. These estimates shown represent the twelve month cost and are derived from this nine month time period. Where a relief is claimed by both income tax cases and corporation tax cases, the cost includes a twelve month estimate of the claims again derived from the 9 month tax year data for income tax cases and a normal 12 month accounting year for corporate claims.
- (2) Seaside Resort Relief has been terminated with effect from end December 1999. The Resort Relief figure relates to an exercise carried out by Revenue and is a very tentative estimate. The figure for the cost of the relief from its introduction until September 2000 (the scheme was introduced in January 1995) is estimated at €317.4 million; the figure shown is an annual estimate.
- (3) The numbers benefiting figure here represents the number of special savings investment accounts at end December 2003.
- (4) The numbers benefiting figure in this case is the estimated number of taxable claimants of child benefit, not the total number of child benefit claimants.
- (5) The cost shown for capital allowances does not include any cost associated with "unused capital allowances", that is, capital allowances which are not absorbed by a company in the accounting period in which they arise because they exceed the amount of the company's profits of that accounting period and which are available for offset. Unused capital allowances can be offset as losses against taxable profits arising in the previous accounting period and against certain profits arising in future accounting periods and can be offset against the profits of another company in the same group of companies. Approximately €2,270 million of unused capital allowances were claimed for carry forward in respect of 1999/00 accounting periods but as the proportion of this item which is included in previous years losses and in group relief is not separately identifiable a reliable estimate of the cost of the capital allowance element cannot be provided.

The accelerated capital allowance schemes for Urban, Rural, Town Renewal, Multi Storey car parks, Student Accommodation, park and ride facilities, living over the shop, Buildings for Third level purposes, hotels, holiday camps and holiday cottages all terminate on 31 July 2006.

- (6) In the absence of other information, tax has been assumed at the standard rate even though a different rate might be appropriate in many cases.
- (7) This is on the basis that the level of investment in the most recent month for which figures are available broadly continues. Based on the figures for tax credit payouts to date in 2004, the estimated full year cost for 2004 is €540 million. The cost of the scheme is affected where participants die, withdraw from the scheme or vary their monthly contributions. The expected costs provided above assume that these variations will broadly cancel each other out. The SSIA scheme will end five years from when the first contribution was made, i.e. between 1 May 2006 and 30 April 2007.

- (8) This is the most recent estimate provided by Revenue; it is not currently possible to capture this figure by way of tax returns.
- (9) Film Relief is scheduled to end on 31 December 2008.
- (10) CGT is not payable where the capital gain is in respect of the disposal of a person's Principal Private Residence. The figure for the cost of this relief makes no allowance for the number of cases where the disposal of the property was on death, and would therefore be exempt from CGT even in the absence of this relief. The Revenue Commissioners have no basis upon which to estimate the proportion of disposals of principal private residences which are sales on the death of owners. If this relief was abolished it would however, in all probability, be necessary to introduce a form of rollover relief for taxpayers changing residence.
- (11) Benefits here include refunds of VRT and VAT on the purchase of the vehicle, VAT (subject to a limit) on the cost of adaptations carried out, repayment of excise duty up to a maximum of 600 gallons and anyone with a primary medical certificate is exempt from road tax.
- (12) The cost of exempting the income of charities, colleges, hospitals, schools, friendly societies, etc. from income tax includes the sums repaid in respect of tax credits and income tax deducted at source (certain dividends, other investment income and payments received under covenant). It also includes the cost of exempting certain bodies from the deduction on income arising from government securities.