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Tax Expenditures

A Submission to the Department of Finance

Irish Congress of Trade Unions

May 2005

Tax Breaks are Tax Expenditures

As Congress completed this submission, we were disturbed to learn that this process of consultation on tax expenditures by the government may not be serious. The report in the Irish Times on 29th April that, in spite of this review of tax incentives, the government is so keen to preserve the tax subsidies to the bloodstock industry that the Minister for Finance was to go to Brussels personally to lobby for its retention. This does not assist in the consultative process. Nevertheless, we will set out our views on the tax incentives/breaks/subsidies /expenditures, herewith.

It is the view of Congress that tax breaks or tax incentives are very similar to *Tax Expenditures.* In other words, tax breaks are very similar to the Government spending taxpayers' euros. They are of course, *subsidies* from the public purse and are also known as *tax breaks*.

However, the impact is different. In some instances, there is no cost to the Exchequer because additional economic activity is generated and no tax revenue has been spent. Instead, money which might not have been made by the additional economic activity is generated and so creates additional revenue which is foregone by the state, as a tax incentive to business. However, where the activity would have taken place anyway, in the absence of tax incentives, then the tax incentive is a waste of precious taxpayers money.

There are however, additional problems with tax expenditures:

1. **Tax expenditures are difficult to quantify in advance.**
   In the past, some with tax expenditures have run into vast sums, costing the taxpayer extraordinary unanticipated and uncalculated sums in lost revenue. Tax expenditures are subsidies. They are the same as a cash handout to business, but with some differences.

   The Government and Department of Finance have had great difficulty in anticipating the cost of tax "incentives," both because they are difficult to calculate as the take up is not known in advance and secondly because they have not sought the necessary information from the beneficiaries to enable them to do so, in some instances.

2. **They are subsidies and have anti-competitive effects.**
   Tax expenditures are subsidies and are anti-competitive. Most economists by nature generally object to subsides, though there is widespread acceptance by many in Ireland of these tax expenditures, probably as many economic commentators are employed by the beneficiaries of them, that is, the lending institutions. This policy of tax subsidisation of investment, which is supposed to assist in incentivising economic activity, is anti-competitive. They are anti-competitive because, for example, they give subsidies in tax breaks to some property-based investments but not to other developments. The European Union has a strong policy in curtailing state aid to private (and some public or state owned) companies,

but does not quantify the cost of these subsidies in its annual report on state aid.

3. **Some of the property based schemes have also led to some urban and rural blight.**
   Property bases tax breaks have also led to some urban and rural blight which would not have occurred at the slower pace of normal development, in the absence of the tax subsidies.

4. **They have unintended consequences.**
   The classic example of the unintended consequences of tax expenditures was the loss of hundreds of millions in lost taxes annually through the so-called Section 84 lending. This was an unintended tax loophole which official bodies like the IDA strongly supported in spite of its runaway cost and gross inequity. It ultimately led to the hugely profitable banks paying no corporation tax, when the nominal rate of tax was 50 per cent and when PAYE workers were forced into paying extraordinary high income taxes to fund the state. The government, wary of the elimination of the loophole overnight, phased it out over time and introduced the Bank Levy.

   The other major un-intended consequent of these schemes has been the aggressive tax planning by a number of tax advisors/consultants which has led to rich people and those with very high incomes actually paying no income tax, whatsoever, while many other high earners pay little income tax.

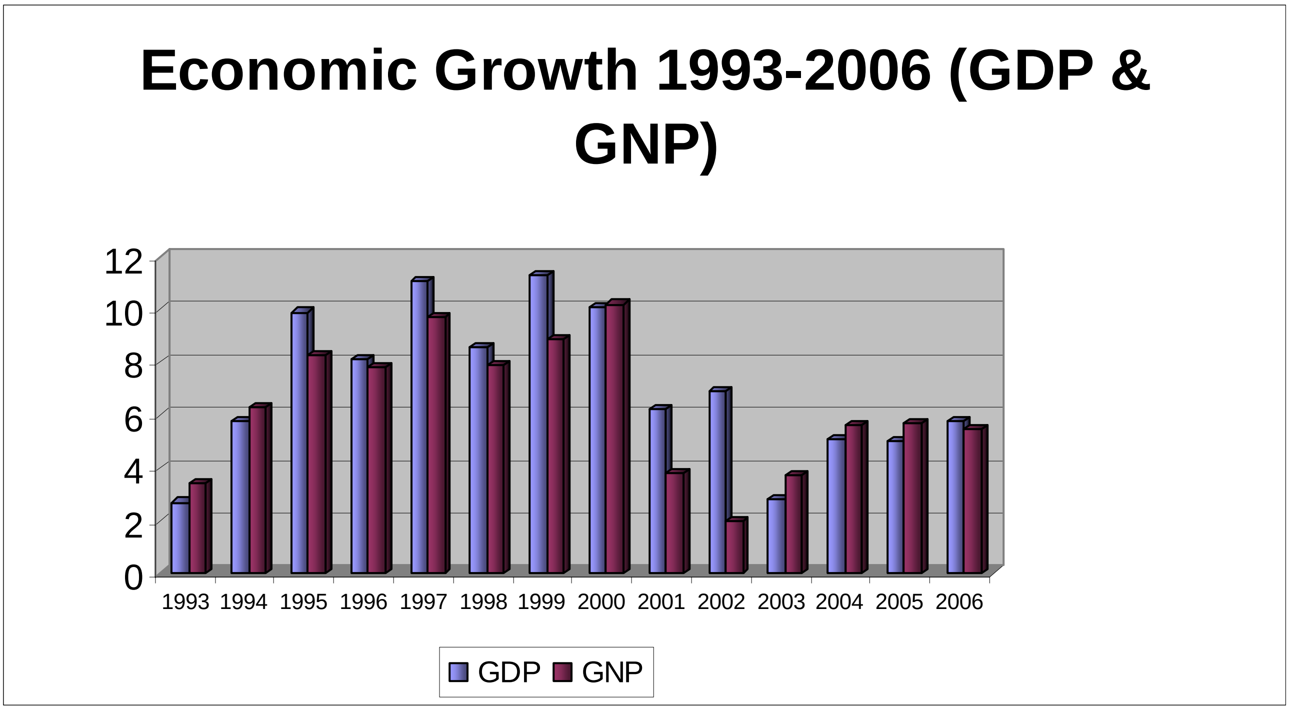
   The prolonged time period of the tax subsidies means that even when they are finally abolished, the loss of revenue persists for ten years in many instances after abolition. Steps should be taken to reduce this tax loss, if possible.

5. **They have boosted construction inflation.**
   They have boosted construction inflation. Construction and asset price inflation has run at high levels in recent years.

6. **Tax expenditures should have a limited time span because of the "diffusion effect", where there is demand for their expansion at the cost of their impact, but generally they are very difficult to terminate.**
   The "diffusion effect", where there is demand for the expansion of tax breaks/incentives to new areas, if area based, or to broaden their scope into other areas. This expansion has the effect of reducing their effectiveness while simultaneously increasing their cost. The narrow group of beneficiaries make up a very strong lobby to retain tax breaks even when their effectiveness is diffused and they are costly. This makes it difficult for the government to terminate them.

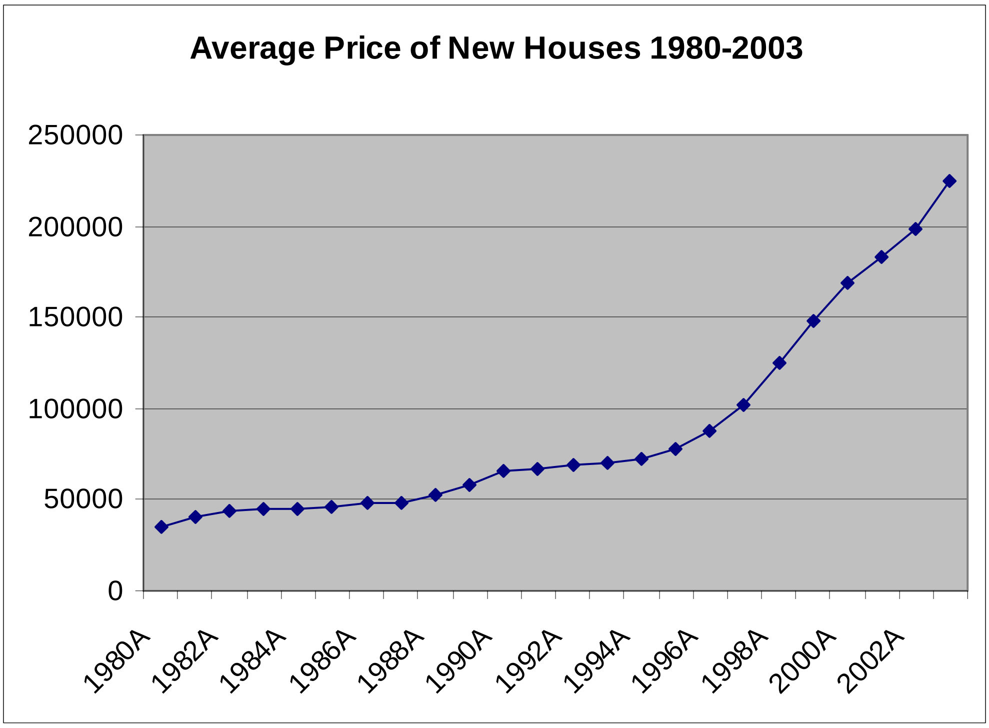
7. **Tax expenditures can be very regressive.**
   Tax expenditures can be very regressive, in generating high rewards to those who least need them, such as the banks in the case of Section 84, or the property based tax incentives. These lost taxes are always at some cost to the poorest because there is never enough tax to pay for worthwhile programmes.

Property Based Tax Schemes
Tax breaks for property investment have been around for almost 20 years. The first major scheme was introduced in 1986 for urban renewal. In the lean 1980s, there was a case for selective incentives to boost property investment but one the economic boom began in earnest in 1994, over ten years ago, all of the schemes should have been terminated by the Government. The economic boom, with exceptionally high growth figures, both in terms of GNP and GDP, are shown in the following graph, when GDP averaged 8.5 per cent over 9 years compared to around 2 per cent in most European countries. To maintain costly incentives to property investment in such times was bizarre. It cost the taxpayer hundreds of millions and redistributed income and wealth upwards.



Source: CSO and ESRI for later year's estimates.

The fact that credit growth has soared and that property-related credit dominates credit growth demonstrates that tax incentives are unnecessary in this booming economy. Credit growth has grown to 27 per cent in early 2005, the highest level in over 5 years - up from a high 18 per cent growth rate in 2003 and property related lending is the dominant area in private sector credit with most of it for residential mortgage lending[1]. Part of the growth in the latter is generated by the Government's tax breaks on property lending which has accelerated house price inflation. The growth in the price of new (and second hand) houses really took off around 1996 as the chart below dramatically shows. The other factors are rising demand, driven by a rising population, by rising incomes and by falling real interest rates.



Source: ESRI databank from DOELG

[1] Central Bank Qterly.

The study by the Revenue of high earners[2] revealed a number of the alarming statistics. It revealed that 12.5% or 50 of the top 400 earners in Ireland paid income tax at an effective rate of less than 10 per cent. Almost 100 paid at less than 25 per cent back in 2001. The Revenue in its study of high earners said “the majority of the 115 individuals whose effective rate for the 2001 tax year was less than 30%, used property-based capital allowance incentives. The total amount of expenditure on which such tax relief was claimed by these individuals for the 2001 tax year was in the region of €42m. The Revenue also admitted that “it was not possible to disaggregate the property-based incentives that generated this tax relief into sub-categories”.

The Revenue[3] tried to take some comfort over very minor reforms which had a minute impact in reducing some of the worst excess of the tax “incentives” which benefited the top earners. It is therefore welcome that these studies are being undertaken today, though a systemic review must be implemented in Budget 2006 to take immediate effect and minimise further tax losses.

Urban Renewal Scheme 1999.
There is no economic, financial or equity grounds for this tax expenditure/subsidy. It should be terminated forthwith and steps should be taken to minimise the benefits which will continue to accrue after its abolition to the beneficiaries. The may have been case for very tightly targeted scheme in some deprived urban area in the mid 1980s, but the circumstances have changed dramatically and did so many years ago.

Rural Renewal Scheme
Similarly there is no sound economic or social reason for this tax subsidy. It should be terminated.

Town Renewal Scheme
Similarly there is no reason for this tax subsidy. It should be terminated.

Living Over the Shop Scheme
There may be a case for this scheme to encourage *a living city*, but a study should be made of the existing scheme by the consultants in terms of its success in addressing its objective, in terms of its cost etc.

Capital allowances for hotels (accelerated 7 year scheme)
There is absolutely no case for this scheme, nor has there been for well over a decade, when tourism began to take off. The hotel industry should rely on the market and not state subsidies for the provision of capital for its investments. It has been used for tax avoidance by high income earners. The number of foreign tourists has more than trebled since 1987, to 6369,000 in

[2] Revenue Commissioners’ Study, Effective tax rates of top 400 earners: report for the tax year 2001
[3] Do.

2003[4]. The number of short home breaks by Irish people has also soared with rising incomes.

Capital allowances for holiday cottages
There is no reason for this tax subsidy. It should be terminated. It has helped generate rural blight in some areas.

Capital allowances for private hospitals (including day hospitals)
Private hospitals should be *private* and not partially publicly funded. There is absolutely no case for this scheme. The "private" hospital business/industry should rely on the market and not state subsidies for the provision of capital for its investments. There is an added unintended consequences of this ill-conceived state subsidy to "private" hospitals and that is, that it is taking precious taxpayers' funding from the public hospital sector.

Capital allowances for sports injury clinics.
There is no reason for this tax subsidy. It should be terminated. Injuries of any kind should be treated in public hospitals. Some public hospitals may chose to specialise in sports injuries related their other specialisms. This public subsidy to these clinics detracts from a coherent approach to the issue.

Capital allowances for nursing homes (including convalescent facilities and associated residential units).

While Congress believes that private nursing homes should be *private* and not partially publicly funded, with the current hospital bed crisis, there may be a case for a modified tax subsidy for this area <u>on a temporary basis</u> until a coherent policy is implemented. The "private" nursing homes business, which is a business and not a charity, should rely on the market and not state subsidies for the provision of capital for its investments. A huge part of the revenue of this nursing home sector is already provided by the state. Similar to the subsidies to the so-called "private" hospitals, the tax subsidies to "private" nursing homes is taking precious taxpayers' funding from the public hospital sector. It undermines the coherence of the health strategy.

Capital allowances for third level educational buildings
Congress cannot see any merit in this scheme. Direct provision for capital investment by the state is the main means of meeting this demand. The curtailment of tax subsidies to property based investments should ease construction industry inflation and so ease the cost of such construction.

'Section 23' type relief for student accommodation
There may be some merit in this scheme but it needs a through financial examination by the consultants to ascertain if there is merit in the scheme. An alternative might be the provision of direct grants to universities/colleges for student accommodation with the taxes foregone under this and other schemes. As stated above, the termination of tax subsidies to property-based

[4] CSO

investments should ease construction industry inflation and assist in reducing the cost of this accommodation.

Capital allowances for childcare facilities
This is one area where there is a strong case for tax expenditures. A state subsidy for the capital cost of childcare facilities, combine with other state aid is urgently required to meet the crisis in the availability of affordable childcare. Not alone is there an immediate problem but unless Ireland facilitates child rearing much more proactively, it will lead to future demographic problems including exacerbated pension funding needs. Such subsidy should be part of a wholistic and coherent approach to the child care problems and in line with our thinking on tax expenditures generally, it should be time limited.

Capital allowances for investment in Multi-Storey Car Parks
There is no economic, financial or equity grounds for this tax expenditure/subsidy. It should be terminated now. The growth in the value of such property alone in itself has greatly rewarded the investors. There is no need for tax subsidies. This capital growth, combined with the strict enforcement of parking regulation, has driven up the occupancy of these car parks to the limit and so greatly boosted the profits of operators. Further it appears as if there is extensive under-utilised street level space which is blocked off by local authorities, partly in their efforts to limit cars in cities, but it has the effect of driving business into these “private” but publicly funded car parks. The consultants should examine the total picture of this business.

Capital allowances and other reliefs for Park and Ride facilities.
Similarly there is a very limited case for this tax subsidy. As above, the strict enforcement of parking regulation has driven up the occupancy of these car parks. In some areas, tax breaks may be helpful, but with the cost of parking in cities and towns, these facilities may pay for themselves, without publics subsidies. Alternatively, it may be deemed that the facilities should be state aided so that charges are kept low in order to encourage the use of public transport from the periphery of urban areas, by those from more remote areas. This needs study by the consultants.

Relief for the refurbishment of certain rented residential properties (Countrywide Refurbishment Scheme)
With the property boom, owners of properties have enjoyed huge capital gains and should not enjoy additional tax subsidies for refurbishment.

In conclusion, most property based tax expenditures should be terminated immediately. It has been seen that they are costly to the taxpayer, are unquantified, add to construction inflation, have unintended consequences etc.

Bloodstock Industry / Stallion Services
Congress was the first body to call for the abolition of this relief in its pre-Budget submission some years ago. Others have followed our lead. We cannot see any merit in this scheme, whatsoever. It main beneficiaries are the very rich. It is totally regressive.

It is disappointing that as this review is being undertaken, the government indicated that it may retain this tax break. If support for an “infant industry” case was made many years ago, it is now long past its sell-by date. It is a mature and flourishing industry which is standing on its own feet for many years and has not needed tax subsidies. It should have been terminated long ago.

Greyhound Stud Fees
Similarly, Congress cannot see any merit in this scheme. It should be terminated now.

Artists’ Exemption.
Congress believes that this was an innovative scheme, to support young and emerging artists. Two reforms are needed. First, the definition of art must be tightened as some of those exempt are hardly working in the realm of art. Secondly, as suggested in our Pre-Budget submission, there should be an income ceiling and/or a limit on the proportion of income which can be relieved of tax. The consultants should confirm that there are benefits generated by those artists who would not live here in the absence of the Exemption. The second (a limit on the proportion of income relieved of tax) would probably ensure that most would stay but still produce income tax revenue. For those with low incomes, there is a case for evening out or spreading income over a period of say three years.

Patent Royalties
There has been abuse of this exemption, with company directors transferring remuneration from fees through these “royalties”. There has been some tightening up but the area needs review. The case for the exemption has to be well made by the consultants with examples of how Ireland has benefited form this scheme, and not just individuals.

Woodlands and Forests
The Revenue is finally assessing the tax lost under this scheme. Again no such tax-exempt schemes should have been allowed without serious efforts to quantify both the cost and the benefit, if any, to the economy and society. And the woodlands subsidised by tax expenditures should be sustainable.

With the shortage of wood in Europe and the environmental benefits of well managed woodlands, there may be a case for this scheme, especially with the need for the reform of the Common Agricultural Policy. However, the consultants should assess if the operations are sufficiently profitable and lead to more sustainable woodlands, without taxpayers’ subsidies.

Investment in Films.
This scheme had brought film production to Ireland which would otherwise not have been located here, generating much needed employment. Thus it appears to pass the test of additionally. There has been tightening up double dipping and other abuses and Congress supports regular monitoring and reforms of Section 481 of the Tax Act 1997 to make it more effective.

Pensions

The issue of tax relief for pension provision, long established, generates savings in the economy and eases the burden of old age for those with pensions. It is universally agreed that more person should have pensions and so the tax relief is a great assistance in boosting pension provision. However, Congress in its pre-Budget Submission has argued that the contribution ceiling should be reduced as it is very high at €254,000 a year.

As part of this submission we attach the Congress Briefing Paper on Pension which was published on 10th May 2005.

High Earners, Tax Avoidance and a Minimum Tax

The Department of Finance sought submissions on measures that could be introduced to limit the extent to which reliefs and exemptions can be used by high-earners to reduce or eliminate their tax bill.

The most recent published information on the matter was set out in a reply to a Parliamentary Question in Dáil Éireann in October, 2004.

This reply indicates that of those in the PAYE sector who earned €100,000 or more in the short tax "year", 2001, 0.4% had a nil net income tax liability, 0.4% had a net liability for tax at the standard or marginal relief rates and 99.2% had a liability for tax at the higher rate. Of the self-employed who earned €100,000 or more in the short tax "year" 2001, 2.1% had a nil net income tax liability, 1.2% had a net liability for tax at the standard or marginal relief rates and 96.7% had a liability for tax at the higher rate.

Overall, there were over 20,000 tax-payers with incomes of €100,000 or more in the "short" Tax Year 2001. Of them, almost 19,700 or 98.1% paid tax at the top rate of 42%; while almost 400 or 1.9% paid tax at 20% or zero. Of these, there were 242 individuals who paid no tax (1.7% of all tax-payers with incomes of €100,000 or more in the year involved).

It is recognised that a number of measures have been introduced to limit the extent to which high earners use reliefs to reduce their tax bill. For example, the 1998 Budget put a general ceiling of €31,750 per annum on capital allowances that could be offset against non-rental income. It is suggested that those making submissions may wish to consider the possibility of a ceiling on all reliefs or limits on the use of reliefs against all income including rental income or other horizontal measures, for example, the introduction of a *minimum income tax* for high earners or the restriction of reliefs so that no more than a specified percentage of income can be excluded from tax by means of certain tax reliefs.

While it is inevitable that people on higher incomes are more likely to benefit from reliefs and allowances more than other taxpayers (because they have the capacity to use more of their income for such purposes) it is clearly unacceptable that in terms of equity that the existence of the various reliefs and allowances can produce a situation where high earners reduce their tax liability to such an extent that they do not pay tax at the higher rate or, indeed, pay any tax at all.

There are various ways to tackle the issue of high earners reducing their tax liability. One that has been mentioned in the Press is a *minimum tax rate*. Superficially, this has some attractions in that it would ensure that one would not have a situation where people on high incomes wind up paying no tax. However, the rate could not be more than 20% (the standard rate) and many current allowances would have to continue to be allowable in full before the minimum rate applied and the Tax Credits would have to continue to be allowed as a deduction from the Tax so calculated. If this were not done, the operation of a minimum rate would have the effect of increasing the tax take on income levels which are not remotely near the levels mentioned above.

As a result, there would be a considerable increase in complexity. In addition, if a minimum tax rate were specified, this would be likely to be seen as the rate at which high earners should pay tax and an encouragement to them to arrange their affairs accordingly in terms of access to allowances and reliefs. Studies which have been carried out in other countries suggest that the introduction of a minimum tax rate has precisely this effect.

While it is unacceptable that some high earners can reduce their marginal tax rates to 20% or zero, one certainly would not want to wind up producing a situation where the 97% paying at the higher rate at the moment had a target of a 20% rate (or less) to aim at.

An alternative would be to seek to limit the amount which could be claimed in respect of each relief either in cash terms or as a percentage of income (or both) and also to have some overall limit (again either in cash or a percentage of income, or both) on the total deductions and allowances which could be claimed, combined with the elimination of many of the tax exemptions as suggested elsewhere in this submission.

This would have the effect of ensuring that high earners could not wind up having a marginal tax liability less than the 42% rate and could have the effect of cutting down on the Revenue loss arising from these reliefs.

Other Tax Expenditures

There are a number of other tax breaks which we believe should be retained in their current form. These include compensation for payments under employment law for infringement of employees rights, payments for permanently incapacitated persons etc.

Conclusion

Congress has set out its objections to the so-called tax incentives or tax expenditures above. These are that :

- Tax expenditures are difficult to quantify in advance.
- They are subsidies and have anti-competitive effects.

- Some property based schemes have also led to some urban and rural blight.
- They have unintended consequences.
- Property based schemes have boosted construction inflation, adding to the cost of homes for young persons.
- Tax expenditures should have a limited time span because of the "diffusion effect", where there is demand for their expansion at the cost of their impact, but generally they are very difficult to terminate.
- Tax expenditures can be very regressive.

We have detailed the few schemes which we believe should remain and we look forward to the analysis of both consultants so of the cost of the schemes over the yeas, annually in lost taxes; of their benefits, if any; of their economic impact, including distortions on the market.

The idea of a Flat tax system where there would be only one rate of income Tax and no exemptions, tax credits or reliefs has been promoted recently in a concerted action by conservative Think tanks around the world. While this has the merit of simplicity, it would be extremely unfair. Congress is opposed to the idea of a Flat Tax system as it is regressive and would greatly benefit the highest earners, while penalising the poorest. As set out in this submission, the termination of most property tax breaks and of exemptions to the Bloodstock industry and Greyhounds and the curtailment of many others would help make the Irish tax system more fair.

There is a case to consider the possibility of a ceiling on all reliefs or limits on the use of reliefs against all income including rental income or other horizontal measures, for example, the introduction of a minimum income tax for high earners or the restriction of reliefs so that no more than a specified percentage of income can be excluded from tax by means of certain tax reliefs. Congress would be wary of a minimum tax as it can have unintended effects, though ceilings can be useful, if well structured.

Congress has set out its policies on other areas of taxation elsewhere, but the dramatic reduction in income tax, where Ireland's rates are now amongst the lowest in the developed world, combined with these many "incentives" and the high taxes on spending and on service charges, have not been progressive. The reduction in the rates of taxes should have been accompanied by the elimination of virtually all of these tax expenditures, simultaneously, so that the marginal and average effective rates came closer together. The elimination of these tax subsides will raise revenue and go some way to making the tax system more fair.

In conclusion, Congress welcomes this opportunity to set out its views on the many tax subsidies to business and individuals which are still in operation in the strongly performing Irish economy. We look forward to finding out how much the tax subsidies are costing PAYE taxpayers every year and to the termination or curtailment of most of them.