TASC

Failed Design?

Ireland's Finance Acts and their Role in the Crisis

"Ireland's over reliance on tax expenditure and tax avoidance to attract investment undermines tax revenue, distorts markets and fails to support job creation."

List of Figures

Following discussion in TASC and consultation with members of TASC's Economists' Network, this report was prepared by Dr Nat O'Connor (Policy Analyst) and Sinéad Pentony (Head of Policy).

Acknowledgements

TASC would like to thank all those members of its Economists' Network who contributed to the development of this report. In addition, TASC would like to thank Dr Micheál Collins, Department of Economics TCD, and the anonymous peer reviewer for their comments and criticisms on an earlier draft.

TASC assumes sole responsibility for the final version.

Foreword

TASC seeks to reduce the high level of inequality in Ireland's society and in our economy. These goals require us to go back to basics and look at the 'economic system' as a whole.

Successive years of Finance Acts have built up rules and regulations that foster the type of economy we have in Ireland, which in turn has led to high levels of economic inequality. The Finance Act 2010 in many ways reflects the direction of Ireland's economy before the crash. Unless we change our whole approach to the annual Finance Act, we risk repeating many of the mistakes that brought Ireland's economy down.

This report is a commentary on the 2010 Act. It also sets this commentary in the context of the wider role of successive Finance Acts in shaping the direction that Ireland's economy took in recent years, with over-reliance on foreign direct investment and tax breaks.

Approaching analysis of the Finance Act in this way is necessary if there is to be an informed debate about Ireland's economic future.

TASC argues that public debate about the Finance Act has been hindered by the intricacy of the legislation, and the complexity of the tax system as a whole. As a result, most coverage has focused on this or that provision, who it will affect, how much tax we will now pay, and so on. While this type of analysis has its merits, there has been a lack of holistic analysis.

Moreover, public debate and public understanding of the Finance Act is not helped by the parliamentary process. Oireachtas powers to scrutinise the national budget are very weak compared to parliaments in other countries, with very little time given to public representatives for its scrutiny. For example, scrutiny of the legislation by the Select Committee on Finance and the Public Service, where the Finance Bill and amendments was examined line-by-line, lasted for just 11½ hours in total over three consecutive days. While sufficient to read the text once, this limited time is hardly realistic for the detailed scrutiny or debate of such complex and technical legislation, and of its implications for the economy.

While this report does not claim to be an exhaustive analysis of the Finance Act 2010, its goal is to question the values informing the Act as well as its economic logic. The Finance Act does little to repair the broken structure of Ireland's tax system, despite the fact that tax revenue fell by a third (€14.2 billion) in two years and the tax base is too narrow to provide for the quality public services that people want. We clearly need real reform of our tax system, to ensure stable, sustainable and sufficient revenue for the State. In addition, there is a continuing over-reliance on tax breaks and incentives for international investment in the legislation and insufficient supports for domestic employers.

It is not possible to eliminate inequality by simply challenging this or that section of one year's Finance Act. It is first necessary to present a vision of economic equality as a goal for Ireland to pursue. Only by building public confidence and support for this vision, is it possible to engage in root-and-branch reform of our Budget, our finance laws and the way we do business. For example, the Finance Act should ensure that everyone in Ireland pays a progressive share of tax, with those who have benefitted more from the economy paying more. The Finance Act should also provide incentives for a sustainable economy, both in terms of environmentally- responsible activity and long-term job creation.

We hope that this report will encourage more people to engage with the 'big picture' questions of values and vision in relation to the economy, as well as the detail of how values become decisions made in each year's Finance Act.

If we change the overall direction of the economy, we can plan for recovery with equality.

Paula Clancy
Director
TASC

Chapter 1: TASC's Analysis of the Finance Act

Introduction

1.1 TASC has written this report to draw wider public attention to the importance of the annual Finance Act to the economy, and to highlight concerns with the Finance Act 2010 in terms of both economic equality and economic efficiency.

1.2 This chapter presents an overview of TASC's perspective on, and analysis of, the Finance Act 2010. Subsequent chapters develop the evidence and arguments in more detail. Chapter 2 explains the Finance Act in straightforward terms and highlights weaknesses in the Oireachtas scrutiny of the legislation. Chapter 3 develops TASC's perspective on economic equality. Chapter 4 examines the State's tax revenue in more detail and the problems with the current structure of the tax system. Chapter 5 examines some of the problems with tax expenditure, which is such a major part of how the Finance Act shapes the economy. Chapter 6 considers the ways in which the Finance Acts encourage investment (especially foreign direct investment) and examines the measures that could be used to support job creation.

1.3 The annual Finance Act has a major effect on the economy. Every year the Finance Act is like a set of signposts, directing activity in the economy – benefitting some areas and disadvantaging others. For example, different levels and types of tax provide incentives and disincentives for economic activity. A major part of the policy decisions made on taxation relate to 'tax expenditure'; that is, tax breaks, credits, allowances and so on, which are often used to divert economic activity and investment into specified sectors of the economy. While less direct than straight Government expenditure, the decisions made in the Finance Act have a powerful influence on the behaviour of individuals and businesses in terms of their investment decisions and the types of economic activity that are encouraged.

A new approach to the Finance Act is required

1.4 We need to reinvent our approach to the annual Finance Act if we are to achieve recovery with equality. TASC's analysis of the Finance Act 2010 is that the Government continues to follow the same design and type of fiscal measures that exacerbated the pattern of 'boom-and-bust' in the Irish economy.

1.5 Ireland is an economically unequal country. TASC argues that we have the means of achieving a more egalitarian society through changing the structure of our economy, including through measures in the Finance Act (among other means). At the same time as generating more equality, it is important to stress that equality and economic efficiency are not necessarily in conflict. They can be made complementary, if the right mix of policies is adopted. For example, policies to foster job creation, education, innovation, better public transport, better healthcare, and so on, all benefit the economy, while also contributing to economic equality.

1.6 The Finance Act 2010 also fails to address the instability and unsustainable nature of Ireland's revenue, including our reliance on too few industries and too few sources of tax.

1.7 The Finance Act could be used to establish a much broader base for State revenue through a greater mix of taxes, including taxes on wealth. TASC argues that the Budget and Finance Act should be guided by an annual study of economic equality (for example, the distribution of income and wealth) and specific provisions should be subject to a strict equality and economic efficiency audit in order to ensure that changes in tax policy develop the economy in a sustainable way and also move it towards equality, rather than increased inequality.

The Finance Act 2010

1.8 The Finance Bill 2010 was introduced in the Dáil on 6 February and became the Finance Act 2010 on 3 April when the President signed it.

1.9 The annual Finance Act puts into law various changes to tax policy brought in at the previous Budget. But much lobbying also takes place between the Budget and the final legislation, and governments often include things in the annual Finance Act that were not mentioned on Budget Day. An example in the Finance Act 2010 is Section 27, which was an amendment brought in after the Committee on Finance and the Public Service had finished scrutinising an earlier version of the Bill. Section 27 extended the end date of a property-based tax break (the Mid-Shannon corridor tourism infrastructure investment scheme) from May 2013 to May 2015.

1.10 Further lobbying occurs after the Finance Act is passed into law, as much of the detail of its provisions are specified in 'secondary legislation'; that is, the regulations (statutory instruments) written by different Ministers, in particular the Minister for Finance. The detail of these final regulations can be decisive in how effective the provisions of the Finance Act are in practice. For example, Section 149 of the Finance Act 2010 imposes a broad legal requirement on tax advisors to report tax avoidance schemes to Revenue. However, the likely effectiveness of this Section will only become evident once the detailed requirements of the provision are spelled out by Ministerial regulation.

1.11 Chapter 2 explains the Finance Act in straightforward terms and highlights weaknesses in the Oireachtas scrutiny of the legislation.

Key weaknesses in the Finance Act 2010

1.12 A central role of the Finance Act is to ensure that the State's finances are stable, sustainable and sufficient to provide quality public services. Recent events indicate the urgent need to re-structure our tax system to achieve these aims, yet Budget 2010 was almost entirely focused on expenditure cuts, and hence the Finance Act 2010 does not make any major structural changes to tax. The extension of VAT to some public services was probably the biggest change, which is likely to be regressive in effect. TASC argues that the effect of the tax system as a whole – not just income tax – should be progressive; that is, those who benefit more from the economy should pay proportionately more.

1.13 TASC's analysis of the Finance Act 2010 calls into question the growth and complexity of the use of tax expenditure in recent decades, under successive governments. The analysis shows the inequality and economic inefficiency that result from their use in many sectors, including private pensions, hotels and health care.

1.14 In particular, there continues to be over-use of tax expenditure to attract foreign direct investment (FDI) and multi-national corporations (MNCs) operating in non-productive sectors such as financial services, which is an unsustainable direction for the Irish economy that will not generate sufficient jobs.

1.15 The Finance Act 2010 is part of an increasingly specialist and technical world of tax law and tax expenditure, which in turn has fostered the growth of a domestic tax avoidance industry, servicing both multi-national corporations domiciled in Ireland for tax avoidance purposes and domestic firms and high-income individuals seeking to minimise their 'tax exposure'. Tax avoidance is not a sound basis upon which to build a strong economy for the future. The Finance Act 2010 reinforces a culture where tax is considered to be a 'burden' to be 'suffered' rather than a pooling of society's resources to benefit from collective activity and provide valuable public services as an exercise in democracy. Ireland's over-reliance on tax expenditure and tax avoidance to attract investment undermines tax revenue, distorts markets and fails to support job creation. Ireland needs to move towards an economy based on sustainable development.

TASC's perspective

1.16 TASC's objective is to bring about economic equality in Ireland; that is, there should be a more equal distribution of society's resources, as part of a well-regulated social market economy. Economic equality can be measured as the combined effect of wealth, income, costs and public services on a person's total net 'benefit' from the economy.

1.17 Economic equality can be measured in different ways, but it has four major components: wealth, income, costs and services. Wealth in Ireland is highly concentrated, yet Ireland has few measures to tax or redistribute wealth. Ireland also has one of the more unequal income distributions in the developed world (ranked 22 out of 30 OECD members) and the highest rate of relative poverty (15 per cent) of all European members of the OECD. These measures of income inequality take account of the ameliorating effect of State payments (such as pensions or benefits), but also illustrate the limitations of the social welfare system compared to other OECD states. The issue of costs also needs to be part of the analysis of economic inequality. Some individuals systematically incur higher or lower costs than others (for example, through tax breaks), which changes their net benefit from the economy. Similarly, subsidised public services (for example, medical cards or social housing) supplement people's benefit from the economy and can counteract other inequalities.

1.18 The Finance Act is one tool that can be used to increase economic equality, through making the tax system more progressive. TASC's analysis highlights certain measures that continue to disproportionately benefit high earners, such as tax breaks for private pensions. At the same time, the Finance Act 2010 does have a number of measures that were flagged to limit tax avoidance. This is welcome as it reinforces the progressive nature of the income tax system. For example, Section 23 increases the minimum rate of tax ('effective tax') from 20 per cent to 30 per cent that certain high earners must pay if they qualify for and use certain tax relief measures.

1.19 One new tax was created by the Finance Act 2010, Section 25, which is a windfall tax of 80 per cent on profits or gains from land, where its value increased due to planning or zoning decisions. This is welcome because it is clearly inequitable for someone to make huge gains solely due to a zoning decision, not through any work carried out. However, this measure has limitations when compared to the Kenny Report's 1973 recommendations: it will not give the State strategic control over land; it is likely to represent poor value for money if the State has to buy land at rezoned prices rather than at pre-zoning use-values; and the proposed measure exempts sites smaller than an acre with a value of less than €250,000. Hence, ribbon-development is likely to continue, to the detriment of the environment, and owners of larger sites will have an incentive to sub-divide them to avoid the windfall tax, which is a disincentive to larger-scale development, where this might represent better land use.

1.20 Under the heading of costs, the Finance Act 2010 lowered VAT from 21.5 to 21 per cent, which should reduce prices by ½ cent per euro. However the Act also extends VAT to cover certain goods and services provided by the State or public bodies, including a number of local authority services such as waste collection or parking. Despite the new lower rate of VAT, the combination of the two measures is likely to have a regressive effect on economic equality, as the additional costs will take proportionately more of the income of lower-income households and outweigh the general benefit of the lower VAT rate.

Alternative economic policy

1.21 TASC argues that economic efficiency has to be measured in a way that includes the public interest and environmental sustainability, rather than being limited to narrow concepts like economic growth (GDP/GNP). At the moment in Ireland, the public economic interest includes the need for the State to have stable and sustainable revenue and the need for solutions to the jobs crisis. A strong economy is needed for job creation and to provide the money for the quality public services that people want and have a right to, in health, education and so on.

1.22 The Finance Acts are one of the primary tools available to Government to restructure the economy and to put in place the supports and incentives for innovation, product development and job creation in Ireland, while rolling back tax expenditure rules that fail to pass equality audits and economic efficiency audits. Tax laws, including tax expenditure, that are introduced through the Finance Acts provide a framework that is as real as the road network in terms of how it affects the economy and provides quicker or easier access to some destinations over others.

1.23 TASC's analysis of the Finance Act also raises wider questions regarding the Government's current economic policy. It is useful to consider some of the bigger picture issues that surround the question of what direction Ireland should take in order to secure its economic future. The elements of an alternative economic and social strategy for Ireland include the requirement to ensure that the economy is shaped and regulated to prioritise the achievement of the public interest. In this context, Ireland needs:

- A strategy to position Irish enterprises and workforce as competitive in global and domestic markets across the full range of indicators, such as education, physical infrastructure, prices and costs, productivity and innovation, and product quality (which has clear implications for investing in skills in order to complete through adding value to goods and services);
- A strategy to deal with both public (national) debt and Ireland's high level of private indebtedness;
- A strategy to reappraise Ireland's level of expenditure – relative to other EU countries with the level of quality public services that Irish people aspire to – in order to set parameters for taxation, spending and managing national borrowing;
- Root and branch reform of banking, including ownership, regulation and governance;
- Root and branch reform of the corporate governance of private, semi-state and public bodies to ensure that the public interest is served in all cases;
- Reform of the political, institutional and legal systems (including the Oireachtas and local government) in order to ensure economic policy is scrutinised and that decision-makers are held to account.

1.24 There is a need for an alternative vision (and a radically different Finance Act) to orient the economy towards diverse industries (including productive foreign investment), innovation and job creation, sufficient State revenue for quality public services, and recovery with equality. TASC's perspective on economic equality is presented in some more detail in Chapter 3.

Taxation and State revenue

1.25 Perhaps the primary function of the Finance Act is to ensure that the State has enough tax revenue to fulfil its functions. Tax revenue should be stable, sustainable and sufficient to provide quality public services. Despite the major crisis in the national finances, the Finance Act 2010 does little to address the collapse in the State's tax revenue.

1.26 The structure of the tax system needs to be broadly based, drawing from all sectors of the economy, so that it can withstand recessions and global financial turmoil. Ireland's tax revenue fell by nearly a third (€14.2 billion) in the two-year period from 2007 to 2009. This fall demonstrated the tax systems vulnerability and over-reliance on certain industries; for example, at least a quarter of the fall in revenue can be explained by the collapse in the housing/construction industry; and tax receipts from construction-related activity are unlikely to ever recover to their previously high levels. Figure 1 illustrates the rise and fall in tax revenue and its annual composition from 2001 to 2010 (projected).

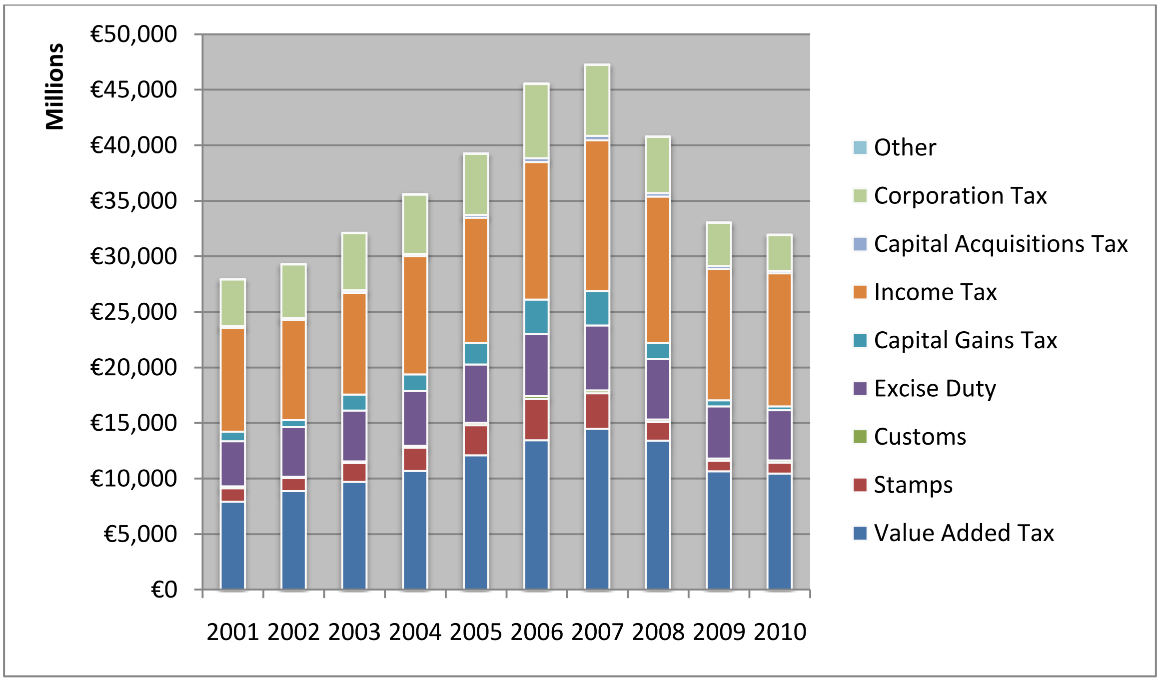

Figure 1. Revenue (2001-2010) in Millions of Euro. Source: Exchequer Returns (several years), Estimates for Public Services 2010. Figures for 2009 are provisional. Figures for 2010 are Department of Finance projections.

1.27 The current composition of tax revenue is unsustainable and increasingly narrow, with heavy reliance on income tax (37 per cent) and consumption taxes (VAT 33 per cent and excise duty 14 per cent) projected for 2010. With €8.40 out of every €10 in State tax revenue coming from income and consumption taxes, solving the jobs crisis is absolutely essential; more unemployment lowers State revenue through income tax and consumption taxes (while increasing State expenditure on social welfare payments). At the same time, more wide-reaching tax reform remains a necessity, not an option.

1.28 A more stable tax system will require taxes on wealth, as well as income and consumption. Taxes on wealth (such as property tax) are more stable during a recession and need to be part of the mix in providing stable and sustainable revenue for the State. Property tax is common in many countries to fund local government and could perform the same function here.

1.29 Ireland's overall tax take also needs to rise in order to be sufficient for the quality public services that most people want. Ireland's level of taxation relative to national income is currently fluctuating due to the crisis, and the subsequent fall in GDP; however in 2007 its pre-crisis stable level was 31.2 per cent of GDP, compared to an EU-25 average of 39.9 per cent (Eurostat 2009). To provide Western European standards of public services it would have to increase significantly. For example, Professor John Fitz Gerald of the ESRI has expressed a preference for "a level of expenditure and revenue in the medium term equivalent to 45 per cent of GDP" (Fitz Gerald, 2009: 15).

1.30 We can also use the Finance Act to make Ireland's tax system more progressive, so that those who benefit more from the economy pay proportionately more. Examples in 2010 include the windfall tax, discussed above, and a new 'domicile levy' (Section 150) that requires high net worth individuals – those whose world-wide income exceeds €1m, whose Irish-located property is greater than €5m, and whose liability to Irish income tax was less than €200,000 – to pay a levy of €200,000. While any measure to ensure that high income individuals pay a substantial amount of tax is welcome, this measure does not represent a major broadening of the tax system because the levy only applies to the small number of individuals with this kind of wealth, not to the broad range of higher earners resident in Ireland.

1.31 The collapse in State tax revenue, the structure of Ireland's tax system and the gap between revenue and expenditure are examined in more detail in Chapter 4.

The economic crisis

1.32 One major issue is how the Government is managing the gap between revenue and spending. Budget 2010 was almost entirely focused on cutting spending, rather than addressing the problems in the structure of Ireland's tax revenue. The Government's projections for 2010 are for year-on-year expenditure to increase, while tax revenue falls. This is clearly an unsustainable situation.

1.33 The State has considerable power to control the level and composition of its income in a way that is different from ordinary households. These options include changing the configuration of the tax system (that is, adjusting the balance of tax on income, consumption and wealth as well as modifying the rules governing tax to increase or reduce the amount that different groups and sectors pay), changing the rules governing tax expenditure (that is, the rules for tax relief, tax credits, tax break schemes, etc) and changing the overall level of State revenue as a proportion of national income. This highlights how the Finance Act is a central part of national policy on the economy.

1.34 Some of the questions raised by the examination of the State's finances are beyond the remit of this report, such as: What mix of policies should be adopted to close the gap between State revenue and spending? How should the level of certain non-discretionary spending (such as welfare payments) be determined? Should capital spending be reduced, held constant or increased (as a stimulus)? Any attempt to prescribe a level of spending, taxes or borrowing/national debt – as well as a package of different measures within these broad aggregates – will require careful, well documented and evidence-based analysis of all the available statistical evidence and modelling of outcomes under various assumptions and scenarios.

1.35 At the same time, with the caveat that complete research and data on these topics are not available, certain key facts can be highlighted which both illustrate the urgency of developing responses to the recession, jobs crisis and collapse of the State's finances, while also pointing to policy choices that fall inside the scope of future Finance Acts:

- Ireland's tax revenue fell by €14.2 billion in the two-year period from 2007 to 2009, a fall of nearly a third. There is a need to ensure that revenue is much more stable in future, and providing stable, sustainable and sufficient revenue should remain the primary function of the Finance Act;
- Major industries which helped to cause the collapse in revenue benefitted from large-scale tax breaks and other tax expenditure. Tax expenditure must not be allowed to promote unsustainable economic activity in future, and the use of such measures in the Finance Act to boost economy activity must not be allowed to undermine the State's tax revenue;
- There is both a need and scope to permanently lower the level of tax expenditure in Ireland, in order to contribute to stabilising the State's finances and ensuring revenue is sufficient for public services;

- The structure of Ireland's taxation system is increasingly narrow. €8.40 out of every €10 in State tax revenue is projected to come from personal income tax and consumption taxes in 2010. The heavy reliance on these taxes needs to be balanced by taxes on wealth (such as property tax), which are more stable during a recession, and other taxes (including corporation tax). Even if the rate of corporation tax is not raised, there is scope to examine the effective rate of tax paid by companies and to reduce tax expenditures that lessen tax take from this area;
- Ireland's overall tax take also needs to rise significantly if it is to be sufficient to provide the quality public services that most people want (at Western European levels).

Tax expenditure

1.36 One of TASC's major concerns with recent Finance Acts is the accumulation of tax breaks, special tax reliefs and other items of tax expenditure. Not only has this made the tax code more complex and less progressive, but it seems that much tax expenditure was provided as concessions to narrow sections of the economy. We should reduce Ireland's reliance on tax expenditure, which has undermined the State's finances, distorted markets and failed to sustain productive investment and employment in areas including the hotels industry, energy efficient equipment, private pensions and private health care. Examples of problems caused by tax expenditures are examined briefly below and in more detail in Chapter 5.

1.37 It is the equivalent of the State spending money every time it puts in place any official rule or scheme that allows an individual or organisation to reduce the amount that they would normally pay in personal income tax, corporation tax, etc. However, the safeguards and accountability for the use of tax expenditure are less than those for direct expenditure. The process for introducing them in the Finance Acts does not fully 'proof' them against common negative effects (see Box 1 below for details).

Box 1. Ten Problems with Tax Expenditure

1) Tax breaks are regressive (that is, they increase economic inequality). They disproportionately benefit those with higher incomes or more resources. Tax expenditure measures on income tax erode the progressive structure of that tax, especially when costs can be off-set against tax at the higher rate;

2) Tax breaks and other tax expenditure are seen as costless or 'revenue neutral' by Government, whereas giving tax breaks is the same thing as the State spending money. Tax foregone through tax expenditure is money lost that the State could have spent elsewhere;

3) Tax breaks and other tax expenditure are effectively subsidies and can have anti-competitive effects;

4) Excessive tax expenditure erode State revenue to an unsustainably low level;

5) The cost of tax breaks is difficult to calculate and is often underestimated;

6) The effect of tax breaks are often 'diffused', whereby they are extended to cover more people or more firms than originally intended, or are extended for longer periods of time or to new areas. This can dilute the incentive effect while also shrinking State revenue;

7) Tax breaks are sometimes given to activities that would have occurred regardless. This is called 'deadweight';

8) Tax expenditure measures can attract unintended users or have unexpected consequences, such as the construction of many more buildings than the economy can use in the near future;

9) Tax expenditure rules can distort markets by shifting incentives from business goals to minimising 'tax exposure';

10) Decisions to extend or expand tax breaks, tax credits or other tax expenditure, including the detail of how they operate, can sometimes be made by Ministers without the constitutional safeguard of a Dáil vote.

1.38 The OECD *Economic Survey: Ireland 2009* report showed that (for 2005) the level of tax breaks on personal income tax in Ireland was proportionately three times the average level of 22 other EU countries, and the level of tax breaks on corporation tax was proportionately seven times the average level of other European countries. TASC estimated that the cost of tax expenditure on income tax and corporation tax alone was €7.4 billion in 2009 (TASC 2009).

1.39 In commenting on the Budget in 2009, TASC proposed that all current and proposed tax expenditure should be subject to an equality audit and economic efficiency audit.

In addition, they should all be subject to an annual check and vote by the Oireachtas, as they constitute a major area of public spending.

1.40 Section 1 of the Finance Act 2010 introduces a new requirement that the Minister for Finance must, within three months, prepare and lay a report before the Dáil giving "...a cost benefit analysis of tax expenditures provided for by this Act, setting out the costs of tax foregone, and the benefits in terms of job creation or otherwise." This provision was a Labour Party amendment that the Government opposed but which was nevertheless passed by the Dáil. The requirement of a cost-benefit analysis is a significant advance in setting controls on the cost of new tax expenditure created by the Finance Act 2010 and ensuring accountability for this to the Dáil. The report is due in early July and the detail of its content will show how far it goes towards the equality and economic efficiency audit that TASC has proposed for all tax expenditure (existing as well as new).

1.41 Another recent initiative is the request by the Minister for Finance for all Ministers to report on the effectiveness of tax reliefs granted under their respective Departments. This initiative builds on the recommendations of the Commission on Taxation report 2009 but is not restricted to those areas of tax expenditure where the Commission recommended changes or abolition. This is a useful initiative, which the Minister signalled would be completed by June and which will inform the preparation of Budget 2011 (*Seanad Debate*, Vol. 201. No. 11).

Pension inequality

1.42 One of the sectors of the economy where successive Finance Acts have had the effect of increasing inequality is in the provision of pensions. Finance legislation has added to inequality in the pensions system by diverting State resources through tax relief for private pensions. These tax breaks cost the State over €3 billion per year, compared to €4.3 billion spent on the State pension, and an ESRI study shows that 80 per cent of the benefit has gone to the top 20 per cent of earners (Callan et al, 2009).

1.43 While the new national Pensions Framework proposes reducing tax relief for private pensions to 33 per cent, this does not address the fundamental equality issues fully. The Finance Act 2010 does little to deal with the problems with the pension system. Section 139 excludes pensions from a one per cent life assurance levy introduced by the Finance Act 2009. This was an added cost that may have deterred lower-income individuals from investing in private pensions. However, other than this change – and some technical reporting requirements – the Finance Act 2010 does not change the current tax treatment of private pensions, or the inequality and economic inefficiency that result from them. This reaffirms that current Government pension policy is reliant on loosely-regulated private pension provision as the means for a replacement income in retirement. It is quite clear that current tax treatment allows the top 20 per cent of high income earners to benefit disproportionately, while the majority of people do not have provision for adequate, secure retirement incomes. And, beyond the minor change to life assurance, there are no provisions in the Finance Act 2010 that would encourage more people to set up secure retirement funds.

1.44 TASC has been advocating pension reform for a number of years in order to eliminate pensioner poverty in Ireland and provide a secure future for everyone, not just the privileged few. The problems in the pension system amount to a crisis for future generations, if radical pension reform is not undertaken. TASC's pensions policy (updated in 2010) advocates a State-led system of pension provision, including a universal social welfare pension set at 40 per cent of gross average industrial earnings, a new social insurance (retirement) fund involving a mandatory defined benefit scheme, limiting income tax breaks for private pensions to the standard rate of tax (20 per cent) and reducing the earnings ceiling on tax relief to €75,000 per annum. Reducing the tax relief to the standard rate of tax would raise €1 billion, which would help fund TASC's proposed reforms and go a long way to eliminating pensioner poverty. TASC's policy document *Making Pensions Work for People* sets out these proposals in more detail (www.tascnet.ie).

Foreign direct investment and employment

1.45 A large proportion of Ireland's economy is based on foreign direct investment (FDI) by multi-national corporations (MNC). For example, nearly one in ten private sector jobs (9.5 per cent) in 2009 was in a MNC. FDI into Ireland was just under €13.7 billion in 2008 (CSO, November 2009). MNCs also employ large numbers of graduates and post-graduates. Consequently, successive governments have used the Finance Acts to create incentives for FDI. However, TASC's analysis is that many measures in recent Finance Acts have been designed to attract FDI without discriminating between productive investment that is likely to lead to employment and non-productive investment, such as the activity of global financial services. For example, an international tax planning company has published a report showing how some of these incentives merely facilitate tax avoidance by MNCs through a hybrid corporate structure known as a 'Double Irish' (WorldTrade Executive, 2007). When this occurs, a lot of the 'investment' money entering Ireland simply passes through without significantly benefiting the economy or society.

1.46 The State can and does distinguish between investment in manufacturing and investment in financial services; however this distinction does not necessarily maximise the incentives for job creation. In some cases, MNCs employ significant numbers of graduates and post-graduates, such as in the pharmaceutical industry. But in other cases, the tax credits appear to simply provide a conduit through which multi-national corporations can pass their R&D expenditure or patents earnings from other countries, in order to benefit from Ireland's tax regime. In exchange, Ireland gains an increase in tax revenue from the presence of these firms, but no significant level of employment is generated here and new products are not being developed in Ireland.

This is a long-term weakness in this strategy, as the opportunity cost of incentives to non-productive FDI is insufficient employment opportunities in the economy. There is a need to continue incentives for FDI that will create jobs, but to reduce or eliminate incentives to FDI that do not result in significant employment. Not all FDI is of the same benefit to the Irish economy and FDI should be judged by its full social and economic benefits, especially employment.

1.47 In terms of tax incentives for financial services, there is a need to improve Ireland's international reputation by strengthening regulation and actively closing tax avoidance schemes. Ireland is under international scrutiny for our current, weak regulation and the extent to which our finance legislation encourages MNCs to move operations to – and through – Ireland in order to avoid tax. For example, in a December 2008 report to the US Congress, Ireland is listed as one of 38 countries identified as a tax haven or financial privacy jurisdiction (US GAO, December 2008).

1.48 As a step towards addressing these concerns, the Finance Act 2010, Section 42, introduces rules to regulate 'transfer pricing' (that is, rules about accurately pricing the sale or transfer of goods and services between subsidiaries of the same corporation, so that tax cannot be avoided through below-cost or above-cost selling). This was in response to international pressure for Ireland to conform to the norms of many other EU and OECD states, which already regulate this area. The American Chamber of Commerce in Ireland has welcomed these rules (ACCI, 2010); however it remains to be seen how strongly enforced and effective they will be.

1.49 Successive Finance Acts (and other Government policy instruments, such as grants and support agencies) have put in place incentives for MNCs to locate in Ireland. These incentives disproportionately rely on tax expenditure, including facilitating tax avoidance. However, Ireland is attractive for other reasons, including the English language, membership of the EU and eurozone, quality of life and the education of its workforce. These incentives should be developed and strengthened as part of Ireland's bid for productive foreign investment.

The jobs crisis

1.50 The jobs crisis (and its effects on State tax revenue and expenditure) underpins the importance of aligning the Finance Act, including incentives for investment, with the primary goal of boosting economic activity that will lead to increased employment. The scale of the jobs challenge is immense, with 267,400 people unemployed in the fourth quarter of 2009, which is just under 100,000 more than one year previously (CSO, *Quarterly National Household Survey*). Many of the jobs losses are due to the collapse of the construction industry. It seems likely that the majority of people who left construction will need to retrain in order to work in different industries, as many of them left education early in order to work during the boom period. Unless the jobs crisis is tackled effectively, there is a real risk of prolonged 'jobless growth' and high unemployment for many years to come.

1.51 Although many of the ways in which the Government can boost jobs involves direct expenditure, Finance Acts can also be used to help job creation through tax policy, by giving tax incentives to firms that maintain jobs or who invest in job-intensive economic activity; however, the actual measures in the Finance Act 2010 are unlikely to foster the growth of many jobs. While this is not its primary role as legislation, the current economic crisis would suggest that all tools available to the Government to boost job creation should be used.

1.52 One example of a potentially useful way of creating jobs through the Finance Act is the support given for research and development (R&D). The current form of these supports is tax credits, which are in practice oriented towards large corporations, especially MNCs. While in some cases, such as the pharmaceutical and software industries, there is significant employment of graduates and post-graduates, in other cases the tax credits appear to simply provide a conduit through which multi-national corporations can pass their R&D expenditure or patents earnings from other countries, in order to benefit from Ireland's tax regime.

1.53 The Finance Act 2010, Section 54 provides further tax relief for R&D, and Section 55 provides tax relief for certain royalties. The way in which the R&D tax credits work seems unlikely to greatly benefit small and medium indigenous firms because the credit assumes that firms are profitable, and hence can off-set investment against tax liabilities. Thus, smaller firms that are breaking even will not be able to benefit. Hence, alternative supports for R&D by smaller firms are also required.

1.54 The Finance Act 2010 reflects a Government economic policy that places MNCs and FDI at the heart of the economy. It does not include many measures that would help diversify the economy or support innovative indigenous enterprise. An economy reliant on MNCs and FDI can only emerge from recession by growing exports and/or attracting further inward investment. In the context of a global recession, there is plenty of evidence that global demand and foreign investment are likely to remain low. Hence, it is necessary for Ireland to develop its domestic economy as part of its recovery including a more diverse, internationally traded domestic sector, as well as investing in infrastructure and education in order to be well positioned to participate in any global upturn.

1.55 More detail on foreign direct investment and job creation (in the context of the Finance Act) is provided in Chapter 6.

Chapter 2: What is the Finance Act?

Finance legislation

2.1 The Government cannot impose tax without passing a law through the Oireachtas. The Finance Bill is published by the Government soon after Budget Day and becomes the Finance Act once the Oireachtas has debated it, made any amendments and enacted it.

2.2 Every year the national budget is followed by two key pieces of legislation: the Finance Act and the Appropriations Act, as well as other key legislation that might not be required every year, such as Social Welfare Acts or tax consolidation legislation. The Finance Act must be enacted within a specified period of months after the Budget, and brings into effect all of the changes to tax policy proposed by the Government in the Budget.[1] The Appropriations Act is the law that allocates public money from the central fund (Exchequer) to the different Government Departments. As the spending requirements of Departments may fluctuate during the year, the Appropriations Act is one of the last pieces of legislation passed every year, in order to confirm the allocation of public money among the Departments.[2]

2.3 Ireland has had Finance Acts since the foundation of the State and most of the provisions of every new Finance Act are amendments to previous Acts. This makes the legislation hard to read for non-specialists, as one needs to refer back to earlier legislation, and to all the other changes made to them. For example, the last time taxation laws were formally consolidated – that is, all the provisions written down in one place – was in the Taxes Consolidation Act 1997. Similarly, there is a VAT Act covering value-added tax.

2.4 The main purpose of the Finance Act is to introduce or remove taxes, and to change the rules governing how taxes work. For example, the Finance Act can introduce or remove tax credits, tax allowances, etc. Various tax relief schemes ('tax breaks') can also be introduced through the Finance Act. The EU has placed limits on State aid to business. However, tax relief can be permitted where the equivalent monetary value in direct State aid would not be.

2.5 The Finance Bill 2010 was agreed by the Cabinet and introduced in the Dáil on 6 February. It was then 'read' in the Dáil, where amendments were made. In particular, a large number of amendments to Finance Bills are typically made during committee stage and some of these later changes can be significant. The Bill was also read in the

[1] Except in those cases where the Minister for Finance may have the power to introduce certain measures, such as levies, by using a power granted by previous legislation. Regulations passed by a Minister are called Statutory Instruments or secondary legislation, and do not have to be approved by the Oireachtas – although the use of these powers must be publicised.

[2] Strictly speaking, public monies are allocated to a series of 'Votes', and each Department receives one or more of these Votes, to be used for the purposes specified by that allocation.

Seanad, but it does not have the power to suggest amendments to any 'money bill' (which includes both the Finance Bill and the Appropriations Bill) and can merely offer commentary. A large amount of lobbying also takes place between the Budget and the final vote on the Finance Act.

2.6 The 2010 Bill became law when it was signed by the President on 3 April. If a Finance Bill is not passed by the Dáil, the provisional arrangements in place since the previous Budget speech would be reversed.

The structure of the Finance Act

2.7 The initial Finance Bill 2010 was the draft legislation (230 pages) and was accompanied by an explanatory memorandum (35 pages), which is not part of the law but is a guide to the various sections of the Bill. The final Finance Act 2010 included a number of changes, often substantial, compared to the initial Bill. Hence, it is important to compare the initial Bill with the final Act to see what changed. The Finance Act has a revised and updated explanatory memorandum. The structure of the Finance Act 2010 is shown in Box 2.

2.8 All of the above are available on the Oireachtas website, on the Department of Finance's website (www.finance.gov.ie) and from the Government Publications Office. In addition, the record of Dáil, Seanad and Committee proceedings is available online and can provide valuable commentary and additional information (www.oireachtas.ie).

2.9 The initial Finance Bill had a total of 155 Sections underneath the structure shown in Box 2. The final Finance Act has 165 Sections plus four Schedules, which resulted from amendments made as the legislation passed through the Oireachtas. Sections relate to specific provisions. Most Sections have detailed sub-sections, sub-sub-sections, and so on, in order to provide exact legal language for the provisions or amendments that they introduce. The explanatory memorandum is very useful in understanding what the Sections are for, although many of them are amendments and require prior knowledge of earlier Finance Acts and other earlier legislation, such as the Taxes Consolidation Act 1997 or the VAT Acts. Certain tax credits or tax break schemes are informally named after the Section in legislation that enacted them. To illustrate the cumulative complexity in tax law, the Taxes Consolidation Act 1997 has 1,104 Sections, comes to more than 700,000 words, and is further amended by the 12 years of Finance Acts subsequent to it.

Box 2. The Structure of the Finance Act 2010

Part 1: Cost-Benefit Analysis of Tax Expenditures

Part 2: Income Levy, Income Tax, Corporation Tax and Capital Gains Tax

Chapter 1: Interpretation

Chapter 2: Income Levy

Chapter 3: Income Tax

Chapter 4: Income Tax, Corporation Tax and Capital Gains Tax

Chapter 5: Corporation Tax

Chapter 6: Capital Gains Tax

Part 3: Customs and Excise

Chapter 1: Mineral Oil Tax Carbon Charge

Chapter 2: Natural Gas Carbon Tax

Chapter 3: Solid Fuel Carbon Tax

Chapter 4: Miscellaneous

Part 4: Value-Added Tax

Part 5: Stamp Duties

Part 6: Capital Acquisitions Tax

Part 7: Miscellaneous

Schedule 1: Rates of Solid Fuel Carbon Tax

Schedule 2: Consequential Amendment of Value-Added Tax Act 1972

Schedule 3: Pre-consolidation amendments and repeals (*Part 4*)

Schedule 4: Miscellaneous Technical Amendments in Relation to Tax

Oireachtas scrutiny of the Finance Bill

2.10 The Dáil is the main forum where the Finance Bill is read and discussed, and where changes (amendments to the legislation) can be proposed. As noted above, the Seanad has a more restricted role in scrutinising legislation involving 'money bills'. The Constitution defines money bills as laws that raise or dispense public money.[3]

[3] Article 20.1 1° "A Money Bill means a Bill which contains only provisions dealing with all or any of the following matters, namely, the imposition, repeal, remission, alteration or regulation of taxation; the imposition for the payment of debt or other financial purposes of charges on public moneys or the variation or repeal of any such charges; supply; the appropriation, receipt, custody, issue or audit of accounts of public money; the raising or guarantee of any loan or the repayment thereof; matters subordinate and incidental to these matters or any of them."

2.11 The Oireachtas's powers to scrutinise the national budget are weak. For example, Ireland is nearly last (joint-28th out of 30) among member-states of the OECD for the short amount of time that parliament gets to debate the national budget. Canada provides a similarly short time and only the UK Parliament has less time to discuss its budget (Sustainable Government Indicators).[4]

2.12 The Dáil votes on the amount of time that is to be given to discuss different sections of the Finance Bill, but because this is by simple majority, the Government has effective control. Discussion of the Bill, especially at committee stage, can be abruptly ended by Government through a so-called 'guillotine', whereby the Government stops speaking time and moves to a vote on the issue. Members may not have a lot of time to consider the implications of amendments, which can sometimes involve major changes. For example, when the Select Committee on Finance and the Public Service examined the 230-page Finance Bill line-by-line, the available time allowed by Government was limited to 11½ hours total, over three consecutive days, with 78 pages of proposed amendments published a few days in advance of the meetings. While sufficient to read over the text once, this limited time is hardly realistic for the detailed scrutiny or debate of such complex and technical legislation, and of its implications for the economy.

2.13 Substantive changes can also be introduced by Government when the legislation is at an advanced stage, which reduces the level of scrutiny received by these measures. For example, Section 27, which extended the end date of a property-based tax break (the Mid-Shannon corridor tourism infrastructure investment scheme) from May 2013 to May 2015, was introduced after the Select Committee on Finance and the Public Service had examined the legislation. In previous years, other major amendments such as tax breaks for private hospitals were introduced at a late stage in proceedings.

2.14 An unfortunate constraint on the Dáil is that members of the Opposition (and Government backbench TDs) cannot make proposals that would spend public money or raise taxes. This is set down in the rules of the Dáil.[5] These rules stem from – but, crucially, also expand – the Constitutional requirement that forbids the Dáil to vote on a resolution or enact a law that would raise or cost public money, unless the Taoiseach signs off in advance.[6] The problem this creates for the citizen is that there is artificiality about amendments that Opposition or Backbench TDs may make to the Finance Bill, as TDs are forbidden from proposing amendments to suggest alternative ways of

---

[4] http://www.sgi-network.org/index.php?page=indicator_quant&indicator=M14_14

[5] Standing Orders 2007, 151.1 "A Bill which involves the appropriation of revenue or other public moneys, other than incidental expenses, shall not be initiated by any member, save a member of the Government."

Standing Orders 2007, 151.3 "An amendment to a Bill which could have the effect of imposing or increasing a charge upon the revenue may not be moved by any member, save a member of the Government or Minister of State."

[6] Article 17.2 "Dáil Éireann shall not pass any vote or resolution, and no law shall be enacted, for the appropriation of revenue or other public moneys unless the purpose of the appropriation shall have been recommended to Dáil Éireann by a message from the Government signed by the Taoiseach."

increasing revenue. From the point of view of evidence-based policy-making and open government, there is a need for reform in this area to allow a more complete exchange of views by TDs in relation to money bills.

2.15 In the current situation, certain major items are also effectively removed from Oireachtas scrutiny, such as some tax expenditure (which TASC estimated cost €7.4 billion in 2009).[7] Although the Dáil must vote to allow tax breaks in finance legislation, Ministers are often given the power in legislation to extend tax breaks, tax credits and other forms of tax expenditure without reference to the Oireachtas. As tax expenditure is the functional equivalent of the Government spending money, the extension of tax breaks, reliefs, etc. by ministerial regulation effectively by-passes the constitutional safeguard that the Dáil must approve taxes and the use of public money.

[7] TASC analysis based on data from OECD *Economics Surveys: Ireland 2009* and correspondence with the OECD (See TASC, December 2009).

Chapter 3: Economic Equality

3.1 TASC's primary concern is economic equality. That is, the resources of society should be more equally distributed – including income, wealth and services. This is not to say that markets do not have an important role to play, where they serve the public interest. Likewise, work and entrepreneurship should be rewarded. But both markets and excessive individual remuneration should be regulated as part of a social market economy.

3.2 There is an element of give and take in every Finance Act. Some people or sectors may pay more tax or lose eligibility for certain tax relief due to one provision, but the same people or sectors might pay less tax or gain eligibility for tax relief from another provision. Hence, it is necessary to look at the sum effect of measures, as well as the cumulative effect of Finance Acts over several years. In some cases it may not be possible to easily quantify the full effects of the provisions; nevertheless certain observations can be made from the perspective of economic equality. TASC argues that the sum effect of the entire tax system should, overall, be progressive; that is, those who have benefitted more should pay proportionately more.

3.3 The key questions in determining economic equality are:

- What is the distribution of wealth?
- What is the distribution of income?
- To what extent do any sectors incur significantly higher or lower costs than others?
- To what extent do public services supplement income?

The central question here is how are the above four factors affected by tax policy and other changes introduced through the annual Finance Act.

Distribution of resources

3.4 Weakly regulated economic activity will result in the accumulation of increasing amounts of wealth in the hands of a relatively small number of individuals and firms. This fact is not seriously disputed, although there is disagreement about the level of benefit that will accrue to the rest of the population from improvements in technology or overall economic growth. One of the purposes of taxation in a democracy is to counteract the inequality caused by untrammelled economic activity and ensure the end-result maximises the public interest, which includes redistributing a proportion of profits.

3.5 Part of the public interest is to encourage innovation, investment and a degree of risk-taking by entrepreneurs in the economy. Financial reward is one way this activity is encouraged. However, beyond that level of reward which serves the public interest, democratic states should progressively redistribute resources. It is important to note that the redistribution of resources does not solely require equal distribution of incomes. Much of what the State does is to provide equivalent resources, such as health, education and housing, which substitute for cash incomes and ensure that most people have a broadly equal quality of life. TASC argues that, in a progressive economy, the overall distribution of resources should also be broadly equal, while still rewarding work and enterprise.

Progressive taxation

3.6 There are four criteria for a progressive tax system. There is broad agreement about the first two criteria, which is that sources of tax revenue should be stable and sustainable. In addition, TASC argues that taxation must be sufficient to allow the State to provide quality of public services. This goal is in tension with Ireland's 'low tax' strategy designed to attract investment. Finally, the tax system as a whole should be progressive, in the sense that those who have benefited more from the economic system – for example, through gaining more wealth and/or higher incomes – should pay proportionately more than those who have benefitted less.

3.7 To elaborate on the last point, it is only by looking at the combined effect of all taxes and public expenditure on people's level of 'benefit' from the economy, that one can judge whether or not the whole system is progressive. State spending on education, health, housing and other areas (as well as by providing incomes through pensions and other social welfare payments) can supplement the economic benefit that individuals gain from the economy as a whole, and hence represent both the value and the redistributive effects of public spending.

3.8 Analyses of public expenditure need to be made at the level of different social groups, as some people benefit less than others from public services and other State expenditure. The question of whether State expenditure is itself progressive in terms of the result for beneficiaries goes beyond what can be examined here in relation to the Finance Act, but it is important to mention the role of public services in completing the picture of what is meant by a progressive economy.

3.9 In terms of taxation, the current Irish *income tax* system can be described as progressive because people on the lowest incomes have sufficient credits that they do not pay income tax, whereas those with higher incomes pay tax at the standard rate of 20 per cent and (if they earn enough) the higher rate of 41 per cent. This is progressive, as those earning more pay proportionately more. However, a progressive income tax system should not be confused with the whole tax system.

3.10 Many other parts of the tax system are not progressive. Consumption taxes, such as VAT, take proportionately more of the incomes of lower income groups, precisely because they spend all or most of their incomes, whereas higher income groups can save money (and defer or avoid consumption tax). This is a regressive aspect of the current structure of the tax system.

3.11 Also the income tax system itself is made less progressive because many higher earners can benefit from tax breaks of various kinds that allow them to pay less tax. Hence, while those with higher incomes may continue to pay more in absolute terms, they may pay less as a proportion of their income relative to the extent to which they have benefited from the economy. For example, until the Finance Act 2010, the minimum rate of effective tax payable by high earning individuals using certain tax relief schemes was 20 per cent. Revenue statistics for 2008 show that earners on €100,000 were paying around 30 per cent in effective tax, thus those people on incomes above €250,000, to whom the 20 per cent rule applied, were potentially paying less. While the Finance Act 2010 introduced measures to raise the level of 'effective tax' for higher earners using certain tax break schemes to 30 per cent (Section 23), the tax advisory industry has been quick to advertise ways of avoiding the full effect of these measures through schemes not listed under the rules for this minimum level of effective tax. Hence, some high earners seem likely to pay less income tax as a proportion of their income than some people on relatively lower incomes.

Wealth

3.12 The State does not provide official statistics on the distribution of wealth, which is a major deficiency that limits the analysis of long-term distributional trends within the economy. In comparison, the analysis of such data is a standard part of the budget process in other countries, such as Norway. TASC argues that an analysis of the distribution of wealth should be carried out routinely by the State. Currently, as a result of the lack of official data, research has to rely on irregular surveys from different sources.

3.13 The best estimate is that the distribution of wealth in Ireland is concentrated in a similar way to wealth in the UK. Given the similarity of the Irish and UK economies in a number of respects, this assumption appears to be reasonable, given that data on income distribution shows similar patterns in Ireland and the UK, compared to more egalitarian EU countries; but with less of a gap compared to the USA.

3.14 The Bank of Ireland *Wealth of the Nation 2007* report relies on the assumption that wealth ownership in Ireland closely mirrors the UK. Based on this assumption "the top 1% of the population holds 20% of the wealth, the top 2% holds 30% and the top 5% holds 40%" (not including people's primary residential housing). Figure 2 shows graphically the structure of wealth described by the Bank of Ireland report.

3.15 The value of assets in Ireland was estimated to be €796 billion in 2005, or €254 billion excluding residential property. Although the value of these assets rose in 2006-2007, a recent Goodbody report (October 2009) estimates that housing assets in 2010 will be nearly a quarter less than 2005 levels; however financial assets will be over a sixth (16 per cent) higher in value in 2010 compared to 2005. Although the value of assets has changed, the basic structure of the distribution of wealth is unlikely to be significantly changed.

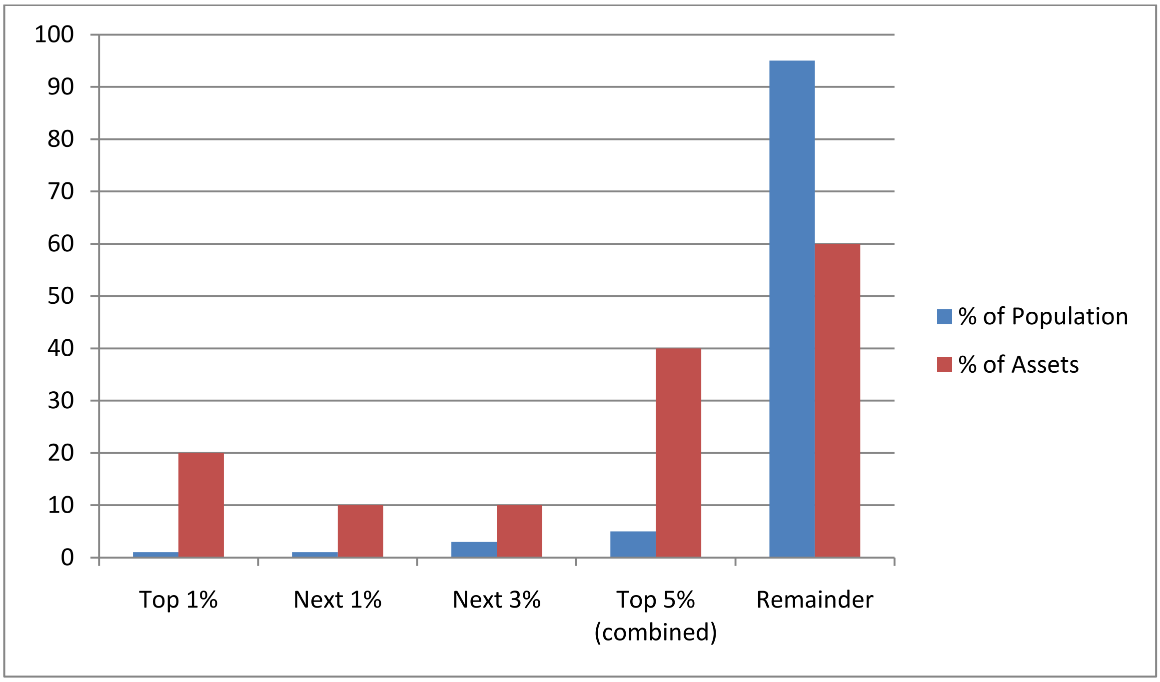

Figure 2. The Estimated Distribution of Wealth in Ireland

3.16 While the distribution of wealth is highly concentrated in many countries, Ireland is unusual in the EU or OECD in having very little taxation on individuals' wealth, such as property or financial assets. The Finance Act 2010 does not introduce any systematic taxation of wealth.

Windfall tax

3.17 The Finance Act 2010, Section 25, extends a windfall tax of 80 per cent to profits or gains from disposing of land where its value has increased due to a planning or zoning decision. This can be seen as an attempt to implement something like the recommendation of the 1973 Kenny Report, which was to allow local authorities to acquire land (for rezoning) at existing use-value plus 25 per cent. The windfall tax provision is welcome as it is obviously not in the public interest for land owners to make huge gains simply due to the rezoning of land.

3.18 One criticism of the Section 25 provision is the exemption for sites of less than one acre and with a value of less than €250,000. The exemption for small sites continues to run counter to coherent planning and seems likely to allow ribbon-development to continue, which in turn leads to over-reliance on private transport, increased costs for the provision of basic services (like water or electricity) and further erosion of Ireland's natural landscape. It will also permit owners of larger sites to sub-divide them in order to avoid the windfall tax, which is a disincentive to larger-scale development, where this might represent better land use.

3.19 A second criticism is that this provision fails to provide for strategic land use by the State in planning public facilities. The Kenny Report's recommendation would have transferred land to local authority ownership before it was rezoned, and thus given the State an opportunity to acquire strategic land for services such as bus lanes, local clinics, post offices, community centres, public green areas, playgrounds, etc, before selling the rest at zoned prices. Under Section 25, if the State were to buy land (at market prices, based on the inflated price created by zoning) it would recoup 80 per cent of those earnings through the windfall tax. However, there is no guarantee that the land owner will agree to sell to the State, which will have to compete against other bidders.

3.20 If land price increases due to rezoning are over 6.25 times the price of agricultural land, then the new provision will represent less value for public money than the Kenny Recommendation of use-value plus 25 per cent.[8] This seems likely to occur; for example, a 2009 land survey found that the average price paid for agricultural land was €10,222/acre (*The Irish Farmers Journal*, 4 March 2010). Data on development land prices is not systematically available; however anecdotal evidence includes a development site in Waterford for €100,000 per acre, down from its previous peak of €700,000 (*The Property Valuer* 2010), a site in Tralee sold for over €400,000 an acre and a site in Louth for €200,000 per acre, down from €400,000. (*The Property Valuer* 2009). Even these lower prices are well above 6.25 times agricultural land prices. A cursory look at asking prices for sites around the country also confirms the expectation that they are often more than 6.25 times agricultural land values (see for example, DAFT.ie).

3.21 The windfall tax is a good example of a measure that allows us to consider the basis of reasonable profit and tax. Under the Kenny recommendation, landowners would gain a 25 per cent profit (above current use-value) from simply owning land that was rezoned. Under Section 25, the amount of profit may be much higher, which begs the question of what is a reasonable level of profit for someone who owns an asset, the value of which is changed dramatically by a political planning decision. In particular,

[8] Kenny formulation: current use-value (say €10,000 per acre) plus 25 per cent = total cost to the State of €12,500 per acre. Windfall tax: State pays market price at zoned value (say €62,500 per acre), but recoups 80 per cent through the windfall tax (€50,000 per acre), which leaves a final cost of €12,500 per acre. Hence, market prices below 6.25 times existing use-value represent better value for public money, whereas those above 6.25 times use-value represent worse value for public money.

what is a reasonable maximum level of public money for the State to pay to a landowner (above use-value) in order to acquire land for public facilities?

Income

3.22 In terms of distribution of income, Ireland remains one of the more unequal societies in the developed world, ranking 22 out of 30 members of the OECD.[9] Ireland also has the highest relative poverty rate (15 percent) out of all European members of the OECD, and the highest increase in relative poverty (4.4 percent) out of all OECD members in the last 20 years.[10] In other words, while average incomes may have risen across the board, higher incomes rose faster than lower incomes – thus the gap widened.

3.23 Rising incomes did lead to a reduction in consistent poverty and other measures of deprivation during the boom period. However, the above facts suggest that, during the sustained period of economic growth from the 1990s to the mid-2000s, the economy – and the role that taxation played in it – was not sufficiently progressive to prevent this gap from widening, despite having some progressive features (such as the higher rate of income tax for high earners).

3.24 It is also salient to note that, as the absolute value of incomes increase, the percentage gap between high and low incomes equates to a greater increase in the purchasing power difference between income brackets. For example, there is the same percentage gap between €20,000 and €40,000 as between €30,000 and €60,000, but in the second case, the purchasing power of the higher income individual is more. Hence calculation of the distribution of income has to include purchasing power as well as relative income levels.

Costs

3.25 The issue of costs is an important and sometimes overlooked component of economic equality. The question is whether any sectors of the economy or sections of society incur significantly higher or lower costs for goods and services. In particular, the question here is whether this is due to State action or inaction. The two major aspects

[9] Ireland ranks 22 out of 30 based on Gini co-efficient. This ranking is generally close to the results of different statistical measures of income equality. OECD members, in order of income equality, are: Denmark, Sweden, Luxembourg, Austria, Czech Republic, Slovak Republic, Finland, Netherlands, Belgium, Switzerland, Norway, Iceland, France, Hungary, Germany, Australia, Korea, Canada, Spain, Japan, Greece, Ireland, New Zealand, United Kingdom, Italy, Poland, United States, Portugal, Turkey and Mexico. 'Measures of Income Inequality' in *OECD Fact Book 2009* <www.sourceoecd.org/factbook>. In January 2010, Chile become the 31st member of the OECD.

[10] 'Poverty Rates and Poverty Gaps' in *OECD Fact Book 2009* <www.sourceoecd.org/factbook> See also, TASC (2009) *The H.E.A.P. Chart - Hierarchy of Earnings, Attributes and Privilege Analysis*.

of the Finance Act 2010 that affect costs are tax breaks or allowances, and consumption taxes.

3.26 Tax breaks which only some sectors of the economy can benefit from, for whatever reason, reinforce economic inequality. If one can claim expenses against future tax one would otherwise pay, then the cost is much reduced compared to those who cannot avail of the tax relief. For example, tax breaks to hotel developers since 1994 allowed 100 per cent of the construction cost to be claimed as a capital allowance against future tax over a period of seven years. However, investors in types of buildings not covered by a tax break scheme had to bear the full cost.

3.27 Conversely, some sections of society, especially marginalised groups, may systematically incur higher costs. For example, geographical location or lack of broadband Internet access may limit the options of some groups in terms of accessing alternative goods and services to what are available locally.

Consumption taxes

3.28 Consumption taxes are taxes on the purchase of goods and services. The main one is value-added tax (VAT). Other examples include excise and carbon tax. Consumption taxes affect different income groups differently. For example, lower income households pay proportionately more of their income on VAT than higher income households. This is because lower income groups typically spend all or most of their income on goods and services, whereas higher income groups can defer or avoid consumption tax by saving or investing surplus income. As a result, consumption taxes like VAT have a regressive effect on the tax system when viewed as a whole.

3.29 Two significant changes to VAT in the Finance Act 2010 are Section 121, which gives effect to the decision announced in the Budget to reduce VAT from 21.5 per cent to 21 per cent, and various sections which extend VAT to certain goods and services provided by the State or public bodies. In particular, this will add VAT to waste collection, parking and other local authority charges, which do not currently include VAT. In this respect, the Finance Act 2010 implements European Council directive 2006/112/EC of 28 November 2006 (which Ireland agreed to at an EU level) relating to the EU's common system of value-added tax.

3.30 Other changes to consumption taxes include the introduction of carbon taxes (Sections 64-87), the lowering of excise on alcohol (Section 88) and the decision to rescind the one per cent life assurance levy introduced in the Finance Act 2009 for certain products, such as private pensions.

Public Services

3.31 Public services, in some cases, provide households with resources that counter-balance inequalities in income or wealth. For example, social housing provided by a local authority is provided at less than market rent levels ('differential rents'), which are linked directly to households' incomes. Similarly, medical cards for low income households provide access to GP services and prescription drugs free-of-charge or at reduced cost to recipients.

3.32 While directly affected by the Budget, this aspect of economic equality is not generally affected by the Finance Act. Funding for public services ultimately stems from the voted expenditure allocated to each Government Department. These are published as the Estimates for Public Services (and later in the year as Revised Estimates for Public Services and occasionally Supplementary Estimates for Public Services). The voted expenditure is confirmed through the Appropriation Act, which is typically one of the last pieces of legislation to be passed annually. It is important to mention this because the Appropriation Act goes hand-in-hand with the Finance Act and provides both context and substantive measures that are relevant to any holistic analysis of economic equality.

Monitoring the distribution of resources

3.33 Unlike other countries, such as Norway, which include studies of the distribution of income and wealth in their annual budgets, the Irish Budget and Finance Act do not appear to pay much attention to how they change the balance between income, wealth, costs and public services – which means that the significant distributional effects of some provisions are not being taken into account. It is a basic requirement for any attempt to increase equality that such data be gathered in a routine and systematic manner to allow these effects to be monitored over time, and for the effects of each Budget and Finance Act to be judged on how they change the distribution of resources in society.

Chapter 4: Tax Revenue and Expenditure

4.1 One of the main purposes of the Finance Acts is to ensure the State has stable, sustainable and sufficient income. Ireland's tax revenue was unsustainable in 2007 and collapsed. One of the main factors contributing to this collapse was the narrow base upon which tax was gathered: the Government was highly reliant upon VAT and Stamp Duty generated by the construction industry and housing sales, along with receipts from both the banking and other financial sectors. These sectors of the economy were reliant in turn on unsustainable levels of borrowing from financial institutions.

State Revenue

4.2 Every country relies on a different mix of taxes, taking money from different sources and at different rates. The relationship between tax types, tax rates and the amount of tax gathered is not always clear-cut. Nevertheless, Figure 3 illustrates the result and shows the relative importance of different sources of tax in terms of the amount of revenue gathered from 2001 to 2010.

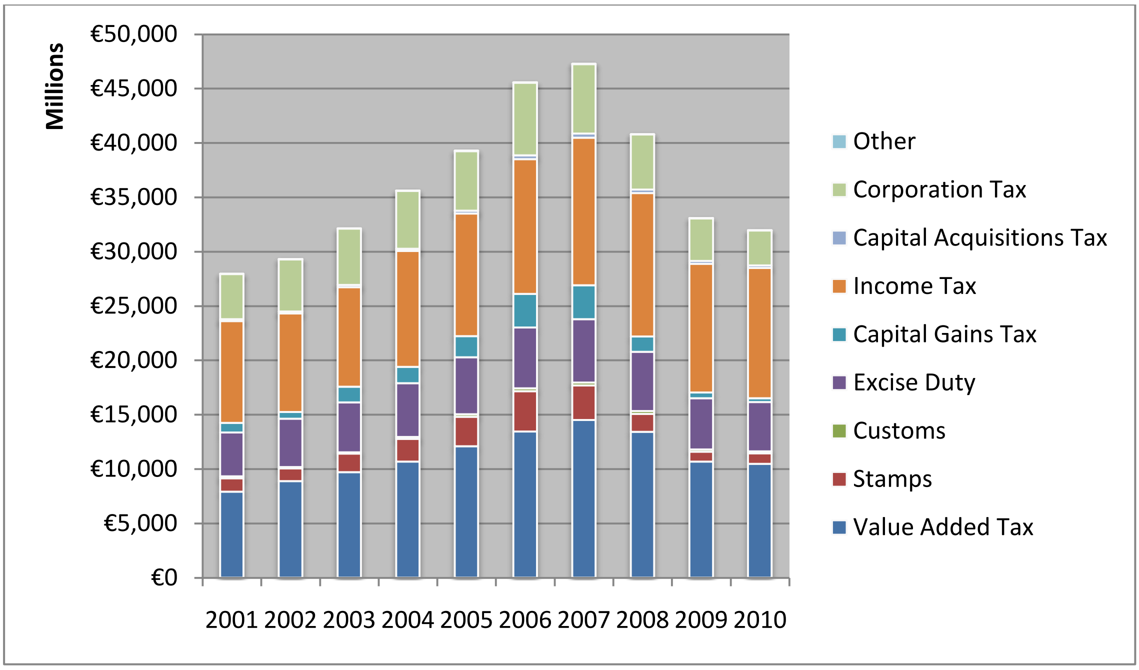

Figure 3. Revenue (2001-2010) in Millions of Euro [Same as Figure 1 above]

Source: Exchequer Returns (several years), Estimates for Public Services 2010. Figures for 2009 are provisional. Figures for 2010 are Department of Finance projections.

4.3 The main feature of tax revenue in this period is the huge growth from 2001 to 2007, followed by its collapse from 2008, and especially in 2009 and 2010, where tax receipts are projected to be €14 billion and €15 billion less than 2007 respectively. Projected tax revenue in 2010 is only €4 billion more than 2001. This shows clearly that the structure of the tax system did not provide a stable source of revenue for the State.

4.4 The increasing role of VAT and Stamp Duty payments from 2001 to 2007 was the other major feature of the structure of the tax system. Combined, these two taxes accounted for a third (33 per cent) of tax revenue in 2001, but this rose to 38 per cent during the period 2005-2007, before falling to 35 percent in 2009. In monetary terms, VAT and Stamp Duty were €17.7 billion in 2007 and €11.6 billion in 2009 (of which VAT accounted for €14.5 billion and €10.7 billion respectively, and Stamp Duty accounted for €3.2 billion and €0.9 billion). That represents a fall of €6.1 billion in two years (of which VAT accounts for €3.8 billion and Stamp Duty account for €2.3 billion).

4.5 A significant part of the fall in VAT and Stamp Duty can be explained by the collapse in the unsustainable construction and housing markets, which were major contributors to VAT and Stamp Duty tax receipts. The fall of economic activity in this sector is also strikingly illustrated by the disintegration of capital gains tax (CGT). CGT represented seven per cent of State tax revenue at its height in 2007, but is projected to provide only one per cent of revenue three years later in 2010. It seems clear that the Government had become highly reliant on the construction sector of the economy for too large a portion of revenue.

4.6 Tax revenue was further eroded by the crisis in the banking and financial sectors, and in turn exacerbated by the international financial crisis and global recession. This is reflected in part in the decline in Corporation Tax, which fell from 14 per cent of all tax revenue (€6.4 billion) in 2007 to 12 per cent (€3.9 billion) in 2009 and is projected to provide only 10 per cent of revenue (€3.2 billion) in 2010.

4.7 The question of the 'structure' of the tax system is important; that is, the different sources of tax that the State relies on. The changing structure of taxation is illustrated in Figure 4, which compares revenue in 2001 and 2007 with projected revenue for 2010.

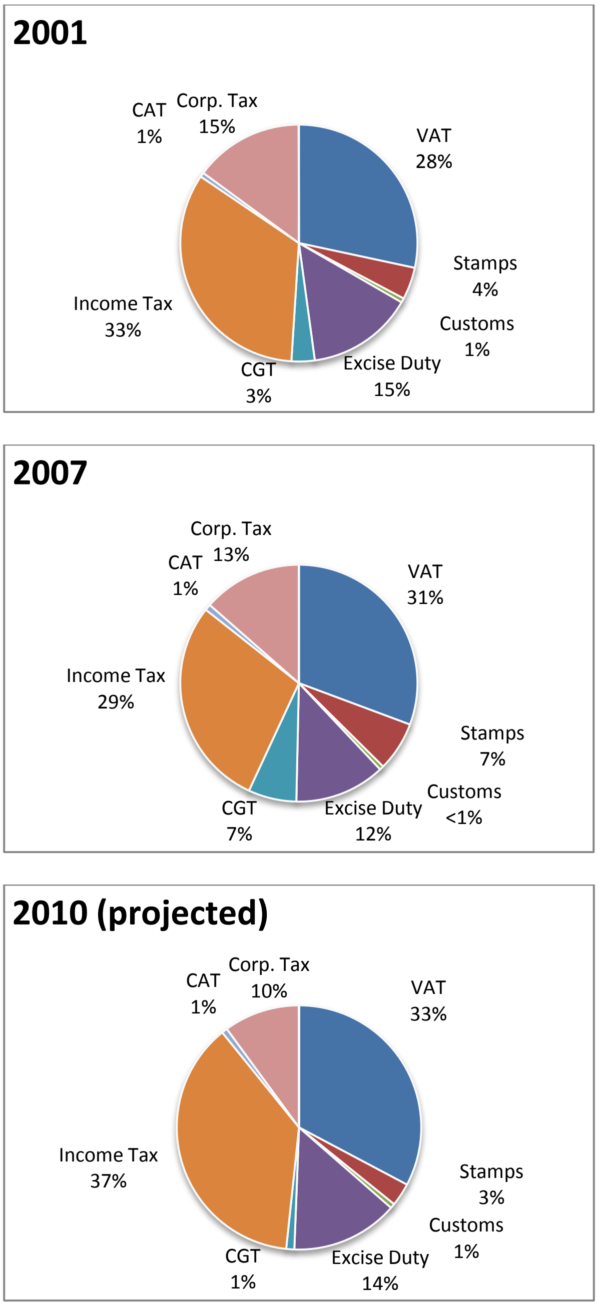

Figure 4. The structure of the tax system in 2001 and 2007 compared with the projections for 2010

Source: Exchequer Returns (several years), Estimates for Public Services 2010.

4.8 Recent discussion of tax reform, such as 'widening the tax base', has tended to focus on income tax changes (in rates or bands) rather than changing the overall structure of the tax system by adding other forms of tax, such as various forms of wealth tax. Possible wealth taxes include tax on property (such as housing), taxes on financial assets and tax on cash savings. As can be seen, income tax was – and is likely to continue to be – a major source of State revenue. However, VAT is nearly as important a source of revenue as income tax, and both excise and corporation tax are also major sources of revenue. Additionally, within each of these categories of tax, it is essential to ask which people or sectors pay proportionately more or less.

4.9 One of the trends within the fall in revenue from 2007 to 2010 is that the proportionately greater fall in other sources of tax revenue in the tax system has shifted a greater reliance by the State on income tax to provide for revenue. The proportion of tax from income tax rose from 29 per cent in 2007 to a projected 37 per cent of all tax revenue in 2010.

4.10 On the one hand, this simply shows that income tax is a more stable form of tax than Stamp Duty, VAT receipts or capital gains tax. On the other hand, dependence on income tax is a major concern because, with falling incomes and job loss, less people are in a position to pay income tax; for example, although it will provide a larger proportion of tax, revenue from income tax is projected to be €11.2 billion in 2010, down from €13.6 billion in 2007. The fall of €2.4 billion in revenue from this source between 2007 and 2010 can be explained by the large increase in unemployment, along with pay cuts reducing revenue from this tax.

4.11 The reduction of revenue from income tax is further evidence of the importance of maintaining and creating jobs to recover the State's finances. In this context, cuts in public spending and wages are not only deflationary in the economy as a whole, but they inevitably shrink State revenue through taxation as people are earning less and consuming less.

The structure of taxation in Ireland

4.12 The structure of taxation in Ireland is different from many other countries in three major respects. Firstly, taxation in Ireland is highly centralised, with almost all revenue being raised centrally and allocations being made subsequently from central Government to local authorities (exceptions include motor tax and commercial rates which are levied locally). In most other countries, local government has more revenue-raising powers as well as responsibility for public spending in major areas, sometimes including aspects of health, education and social welfare.

4.13 The second difference between Ireland's tax structure and other countries is the absence of any significant tax on housing or property. In many countries, this provides a major portion of funding for local government. Property tax is also less vulnerable to economic cycles (that is, it is less likely to fall as much during a recession or to grow during a boom period). The instability of State revenue during recent years is clear evidence that more stable sources of revenue are required in the tax system. The Commission on Taxation Report 2009 recommended the introduction of an annual property tax on residential housing. A €200 property tax (per housing unit) was recently placed on second or subsequent housing units.

4.14 The third difference is that Ireland has a much higher level of tax expenditure on average than most other EU countries, a point which is examined in much more detail in Chapter 5.

The extent of taxation in Ireland

4.15 Ireland's tax revenue has for a number of years been a lower proportion of national income (as measured by GDP or GNP) compared to other EU countries. Ireland's level of taxation relative to national income is currently fluctuating due to the crisis, and the subsequent fall in GDP; however, in 2007 its pre-crisis stable level was 31.2 per cent of GDP, compared to an EU-25 average of 39.9 per cent (Eurostat 2009). To provide Western European standards of public services it would have to increase significantly. For example, Professor John Fitz Gerald of the ESRI has expressed a preference for "a level of expenditure and revenue in the medium term equivalent to 45 per cent of GDP" (Fitz Gerald, 2009: 15).

Service charges

4.16 A final concern with State revenue is where the State shifts the source of funding for some activity from taxation to charges. For example, local authorities levy waste charges and commercial water charges. Domestic water charges have also been proposed. There are two sides to the argument about these charges. In isolation, they are regressive, as people on lower incomes pay more as a proportion of their income. However, they have potentially positive ecological benefits as they motivate people to consume less or recycle more, in line with the 'polluter pays' principle.

4.17 In order to reconcile these positions, the State has two options. Either people must be guaranteed a minimum level of income (based on their specific needs) so that each can afford to pay water and waste charges, or else these charges must be treated as part of the tax system (as paying for water and waste collection is generally not optional). In the latter case, people on lower incomes should have waivers or exemptions, or else other measures to increase progressivity in the tax system as a whole should be taken to counteract the effect of these charges.

State expenditure and deficit

4.18 State revenue goes hand-in-hand with State spending. It is obviously not possible to judge whether State revenue is sufficient without an analysis of how much money the State needs to spend. Conversely, the extent of State expenditure is limited by the resources of the country (in terms of State assets and resources, national income, wealth reserves, balance of trade, etc).

4.19 For the purposes of analysing the Finance Act 2010, it is useful to look at the revenue of central Government, as this is what is allocated by the Budget. This involves tax revenue, as well as one-off 'capital revenue', such as money from selling State assets. However, central Government revenue does not include all forms of State revenue, such as the income of publicly-owned companies. Central Government's revenue is illustrated in Figure 5, which compares this revenue with expenditure, including capital (one-off) expenditure.

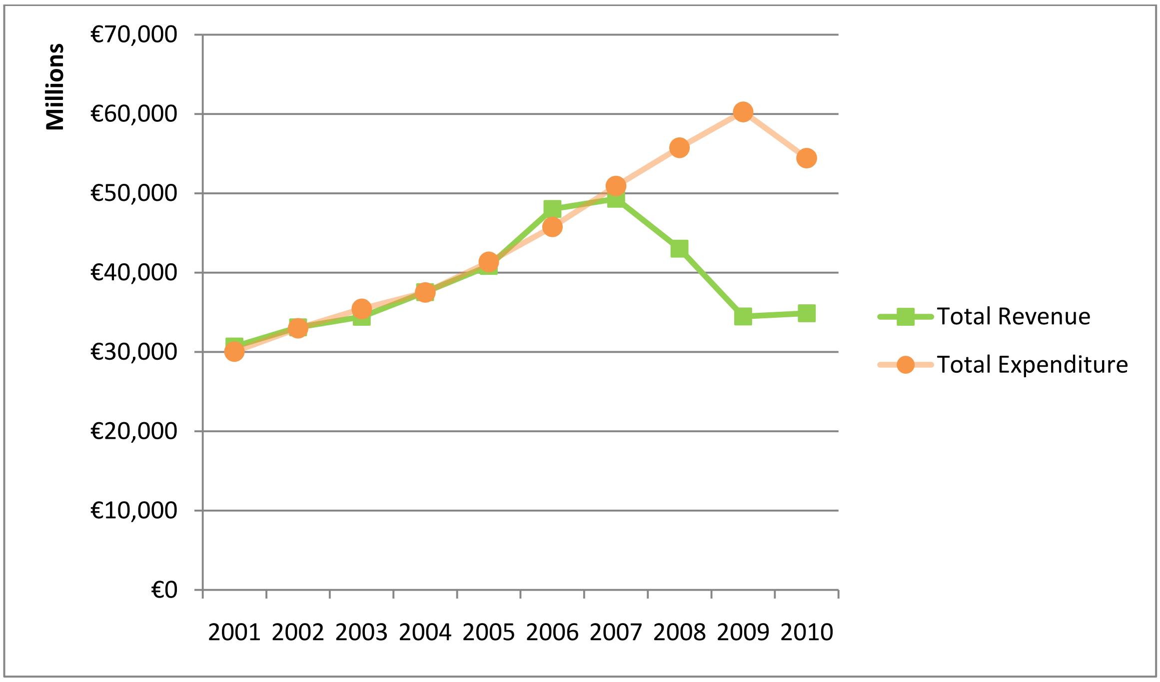

Figure 5. Central Government Revenue and Expenditure (2001-2010), in Millions of Euro, net figures

Source for 2001-2008 data: Department of Finance (2009) *Budget and Economic Statistics 2009*. Source for 2009-2010 estimated data: Department of Finance (2009) *Pre-Budget Outlook November 2009*. Figures for 2010 are projections.

4.20 What Figure 5 shows is that central Government's revenue and expenditure were broadly aligned from 2001 to 2007. The crisis in the State's finances is clearly illustrated from 2008 onwards. At this point, spending grew, whereas revenue collapsed. In 2009, expenditure continued to increase, but at a decreased rate due to cuts in public spending, including cuts to capital (one-off) spending. Total expenditure for 2010 is projected to decrease. The gap is estimated to be €25.8 billion in 2009 and €20.5 billion in 2010.

4.21 The gap has decreased because the State plans to make less capital expenditure in 2010, as well as making cuts in current spending, including in social welfare (although total current spending is still increasing). Also included in the figures are payments to the National Pension Reserve Fund. The State has been making an annual payment to the fund, but the Government chose to move €3bn into the fund in 2009, including an advance payment of €1.5 billion that would otherwise have been made in 2010. The projected increase in revenue is from non-tax sources such as selling State assets, the pension levy or property registration authority fees.

Tax revenue and current spending

4.22 In order to analyse the core, year-on-year income and spending of the State, it is necessary to cut one-off spending out of the picture. The above illustration (Figure 5) is distorted by the Government's decision to cut capital expenditure from €14.7 billion in 2009 to just under €7 billion in 2010. That is a total cut of €7.8 billion in capital expenditure (of which €4.8 billion represents cuts unrelated to transfers to the NPRF). The next illustration (Figure 6) shows the core of the State's finances by comparing only tax revenue with current expenditure.

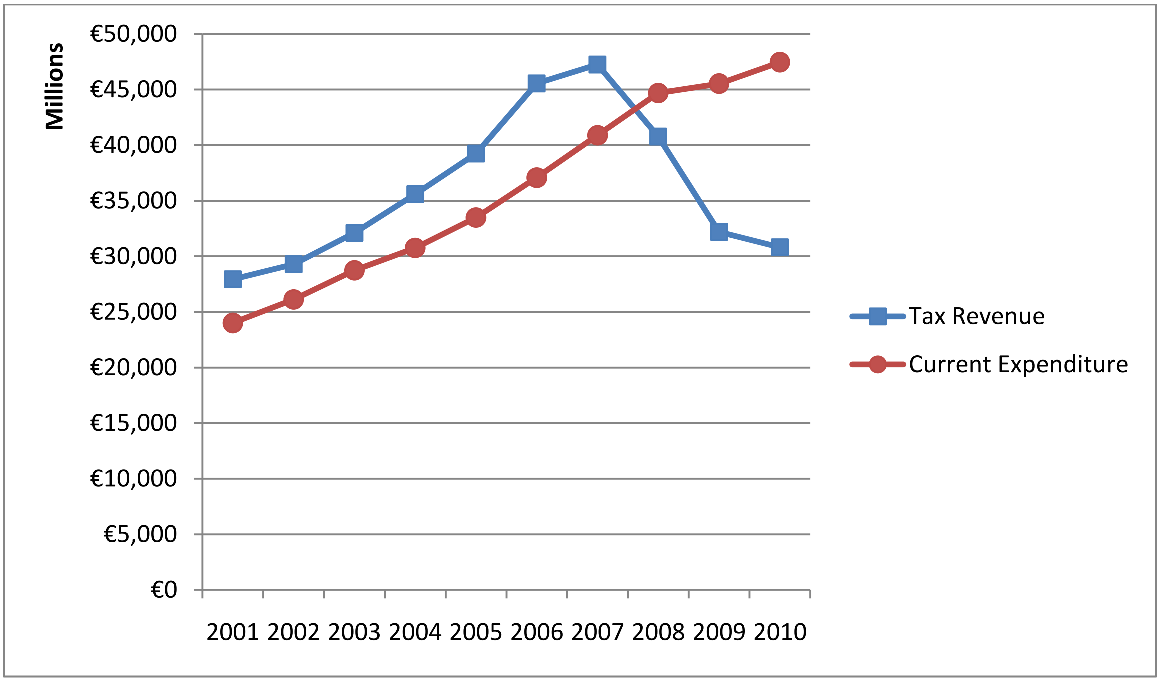

Figure 6. Tax Revenue and Current Expenditure (2001-2010), in Millions of Euro, net figures

Source for 2001-2008 data: Department of Finance (2009) *Budget and Economic Statistics 2009*. Source for 2009-2010 estimated data: Department of Finance (2009) *Pre-Budget Outlook November 2009*. Figures for 2010 are projections.

4.23 The line showing tax revenue naturally has exactly the same shape as shown in Figure 3 at the beginning of the chapter. As explained earlier, the fall in tax revenue can be explained by the fall in revenue across the board, especially the collapse in Stamp Duty, VAT and capital gains tax.

4.24 One can also see in Figure 6 that tax revenue was significantly higher than current expenditure for the period 2001-2007. This permitted the State to fund capital expenditure out of current revenue, which is relatively unusual compared to other countries, as capital expenditure is typically financed through borrowing. As in Figure 5, the crisis in the State's finances is clearly shown by the gap between revenue and expenditure from 2008. The yearly gap between spending and income is called the 'current deficit' to distinguish it from the overall deficit (national debt).

4.25 The gap between tax revenue and current expenditure, as shown in Figure 6, was €3.9 billion in 2008, and is projected to be €13.3 billion in 2009 and €16.7 billion in 2010. However, it should be noted that non-tax sources of current revenue will lessen this gap by c. €800 million in 2009 and c. €2.3 billion in 2010. Figure 6 does not include current non-tax revenue such as the pension levy, other receipts collected by Departments, property registration authority fees, interest on loans granted by the State, etc. (see for example, *Exchequer Statement*, January 2010). As mentioned above, the collapse in revenue is further exacerbated by the fall in incomes as Ireland's economy deflates. At the same time, despite welfare cuts, the number of people claiming social welfare benefits is increasing the State's expenditure in this area.

Economic cycles

4.26 At this point it is important to make the observation that the State's finances are not like those of an ordinary household. It is correct to observe that, like everybody, the State cannot indefinitely spend more money than it has. But one difference is that the State is affected by economic cycles in a predictable way that ordinary households are not, and another difference is that the State has options for organising its revenue that are very different from the options available to ordinary households.

4.27 Economic activity in Ireland (in common with other capitalist economies) is known to expand and contract over the years. As economic activity expands, so too does tax revenue, and as economic activity declines, tax revenue follows suit. Following this logic, it is reasonable to expect that as the global economy improves, economic activity in Ireland will pick up, and hence tax revenue will also increase.

4.28 From this perspective, it makes sense for the Government to do what it can to encourage economic activity during a recession, and to be prudent and pay off the national debt during an expansion of the economy. The Department of Finance's *Pre-Budget Outlook* claims that a quarter of the gap is cyclical, in the sense that it a regular upsurge in economic activity will only close a quarter of the gap (page 34); however, the Department cautions that "it is very difficult to forecast cyclical influences beyond the short-term" (page 15). An ESRI paper from May 2009 is less pessimistic and estimates that half the gap arose "from the global financial and economic crisis" and "would have happened anyway no matter how appropriate fiscal policy had been over the last decade" (Bergin et al 2009: 1).

4.29 If between a quarter and a half of the gap in the State's finances is cyclical, the remainder is 'permanent' or 'structural' – in the sense that economic growth alone will not close the gap and other measures need to be taken.

4.30 Unlike current (year-on-year) spending, most capital spending does not create a permanent gap in the State's finances as it is one-off and not recurring on an annual basis. It does add to the national debt, and must be paid off over time. However, a small amount of capital spending should be regarded as an annual necessity to pay for the repair and upkeep of national infrastructure (such as the roads or telecommunications infrastructure), otherwise the infrastructure literally starts to fall apart and incurs much greater costs in repair and to the wider economy; for example, the British Treasury estimates the depreciation of public capital stock to be 1.4 per cent of GDP.

4.31 In addition to the cost to the economy of not maintaining public property and infrastructure (such as roads, bridges and railways), investment in capital projects can increase efficiency in the economy and boost economic activity; for example, investment in telecom infrastructure can facilitate broadband Internet access, which in turn gives more consumers and firms access to new products and services.

4.32 Advocates of a State-led economic stimulus argue in favour of borrowing to spend on capital projects during a recession. The advantage of this is that it can sustain and generate employment and other economic activity, thus boosting the economy generally, reducing spending on social welfare, increasing tax receipts and positioning the economy to make the most of any future global recovery.

The current deficit

4.33 One major contrast between Figure 5 and Figure 6 is what each suggests about how the Government is managing the gap between revenue and spending. Figure 5 shows a slight rise in revenue and a decrease in projected expenditure for 2010. However, Figure 6 shows the reverse. As outlined above, the reason for this is that Figure 5 includes irregular income and spending. Figure 5 includes capital (one-off) spending, and the big cuts in this area in 2010, compared to 2009, makes total spending decrease. However, as illustrated in Figure 6, year-on-year expenditure is projected to increase, while tax revenue falls. Despite the cuts in social welfare, expenditure increases are in no small part due to increases in the number of people on the live register claiming social welfare benefits (434,700 people in January 2010, an increase of 110,600 from the year before). The Government's welfare spending estimates increased by nine per cent or €1.8 billion between 2009 and 2010 (*Pre-Budget Outlook November 2009*).

Euro stability and growth pact

4.34 Among the major constraints on the State's fiscal policy are the stability and growth pact (SGP) rules of the Euro currency zone in relation to the level of the current deficit (maximum three per cent of GDP) and national debt (maximum 60 per cent of GDP). Ireland's current deficit is far higher than three per cent, at 14.3 per cent,[11] but Ireland's national debt of €76 billion (NTMA, January 2010) is relatively low as a proportion of GDP compared to other EU states. Plus, Ireland had some cash reserves in the form of c. €20 billion in the National Pension Reserve Fund (much of which has been used for bank recapitalisation). In the current crisis, many Eurozone countries have breached the Euro's SGP limits, but have negotiated with the European Commission about when they will realign their economies with these restrictions. The Government has committed to doing so by 2014.

4.35 The length of time required to restore balance to the State's finances is hotly debated. Most commentators in favour of stimulus and other job retention/job creation proposals suggest extending the period. Various commentators, including Commission President Romano Prodi in 2002, argued that the narrow parameters of the SGP would limit Government spending in a recession and limit stimulus-led growth (which is the current situation). While the SGP rules may align with the dominant economic orthodoxy, they cannot be seen as a mechanism based on purely economic logic, as they reflect the political compromise reached by EU leaders when setting up the Euro currency rules.

The Finance Act and revenue

4.36 It is important to note an observation made by the ESRI team in relation to the 'permanent' or 'structural' part of the gap in the State's current finances: the "structural deficit is almost wholly due to past mistakes in fiscal policy." They write that "the legacy effects of past policy mistakes make things much worse in Ireland than they would otherwise have been" (Bergin et al 2009: 1). This brings the focus clearly back to the annual Finance Act.

[11] 'Ireland's deficit highest in EU in 2009' (*RTÉ News*, 22 April 2010)

Chapter 5: Tax Expenditure and Economic Inefficiency

5.1 An important strand of TASC's current research focuses on a number of inter-related areas to do with taxation. TASC is particularly concerned at the level of tax breaks and other ways to avoid tax in the Irish system. The OECD *Economic Surveys: Ireland 2009* report showed that (for 2005) the level of tax breaks on personal income tax in Ireland was proportionately three times the average level of 22 other EU countries, and the level of tax breaks on corporation tax was proportionately seven times the average level of other European countries. TASC estimated that tax expenditure on income tax and corporation tax alone cost the Irish Exchequer €7.4 billion in 2009.

5.2 What this means is that a much greater proportion of tax is legally avoided in Ireland, compared to other EU countries. This occurs through a range of formal tax break schemes and other mechanisms in the tax code. This has a number of undesirable effects, including instability in the tax base and, more destructively, market distortion, where product development and added value (and in turn increased employment) become less attractive to investors compared to tax break schemes.

5.3 To understand a number of measures in the Finance Act 2010 it is necessary to see how years of Finance Acts increased tax expenditure for the benefit of both international investors and elements of the domestic economy.

Tax expenditure

5.4 A very simple depiction of the tax system is as follows:

- A firm or individual gains **income** from selling goods/services;
- The firm/individual can deduct a series of **legitimate expenses** from this income before determining how much money was actually gained;
- The firm/individual declares the amount of income less expenses (or **taxable income**) as part of their annual accounts and tax declaration (although some incomes are **tax exempt**);
- The firm/individual deducts **tax credits** from the tax liability (for example, all individuals have a set of personal tax credits). Additional credits are available for making specific types of investment;
- If the firm/individual invests in certain **tax breaks/reliefs** these can also reduce the amount of tax to be paid;
- The firm/individual pays **tax** according to whatever category of occupation and level of tax applies to the area of work (for example, industry, farming, etc).
- In some cases, firms/individuals can apply for **tax refunds** to recover tax paid in previous years if they make a loss in the current year.

5.5 The very basic personal tax credits that individuals receive can be regarded as an integral part of the tax system. It is the same thing as charging zero tax on very low incomes. Beyond personal tax credits, every tax credit and tax break scheme, plus tax exempt income, along with what is allowed as a legitimate expenses to be deducted from income, as well as any other legal way of avoiding tax can be categorised into a collective, technical term: '**tax expenditure**'. Tax expenditure is any official rule or scheme that allows an individual or organisation to reduce the amount that they would normally pay in personal income tax, corporation tax, etc.

5.6 Tax expenditure is 'expenditure' because the decision to allow individuals or firms to pay less tax is the equivalent of Government spending money to support those areas of activity. Tax foregone through tax expenditure is money lost that the State could have spent elsewhere. Hence, for example, a tax break for installing home insulation is the equivalent of a direct grant payment to homeowners to do the same – except, crucially, the schemes may differ in who can apply or the level of benefit that different people gain from the system.

The problems with tax expenditure

5.7 Tax expenditure is inherently inequitable and regressive, because only those who earn enough to be normally eligible to pay tax are able to benefit from tax reduction, and those who earn more can benefit more. The regressive nature of tax expenditures is particularly acute with regard to personal income tax when a tax break applies to the higher rate of tax, as high earners gain a disproportionately higher benefit. The example of Ireland's tax breaks for private pensions shows that 80 per cent of the benefit goes to the top 20 per cent of earners (Callan et al, 2009). In theory, the tax break to pensions is tax 'deferred' that will be paid later when the pension funds are drawn down as income, however some of this deferred tax is never realised, for example due to other tax exemptions that allow a tax-free lump sum to be drawn down from the pension fund. The OECD noted in its 2008 *Economic Survey of Ireland* that many pensions are unlikely to be fully taxed at any point in the lifecycle, which means that the Exchequer never fully recoups the revenue forgone through tax relief on pension contributions. While the new national Pensions Framework proposes reducing tax relief for private pensions to 33 per cent, this does not address the fundamental equality issues fully.

5.8 A number of other problems have been identified with tax expenditures. They are often perceived as 'costless' in the national budget, because they are not accounted for. Hence, there can be a willingness to allow tax expenditure where direct State expenditure would come under much greater scrutiny (and may be forbidden under EU competition rules against State subsidies). Unlike items of budgetary expenditure, tax expenditure can have an unknown cost, as it is harder to predict how many firms/individuals will avail of the option.

5.9 The cost of tax expenditure can be higher than predicted and there is a tendency for 'diffusion', which means that there can be pressure to extend the scope of tax expenditure if it is seen as successful or has disproportionately benefitted one sector over another. This can lead to tax breaks being extended in duration or to additional groups or locations. Likewise, the rules governing tax expenditures can allow individuals/firms to legally avail of them despite never having been the intended targets.

5.10 One of the negative features of successive Finance Acts is that provisions are put into the legislation to benefit a small number of enterprises or entrepreneurs, or even individuals in some cases. These tax breaks are sometimes called 'concessions' in the industry jargon, in the sense of the Government conceding something in order to attract investment. The beneficiaries of concessions may be major employers or investors in Ireland, or they may simply be persuasive lobbyists. In many respects the Finance Acts have become a patchwork of concessions, which leads to a lack of overall coherence in fiscal policy that works against stimulating economic progress and employment. For example, at the height of the boom period when property development was a major source of economic activity, promoted in turn by tax breaks on investment in property, those who benefited from the sale of land for development were given a further special incentive tax rate (introduced in the Finance Act 2000) of 20 per cent, whereas most of them would have been liable to pay the higher rate of income tax of 41 per cent on most of their incomes (*RTÉ*, 2 December 2009). The special tax rate for development land is only one example of how the tax system in general has been undermined by tax breaks and other arrangements to lower tax for certain sectors.

5.11 Tax expenditure – especially tax break schemes – can lead to unintended consequences, such as the construction of many more housing units or hotels than the economy can use in the near future. At an extreme, tax expenditure can distort markets by diverting the calculation of most profitable activity away from core business activity (producing and adding value to goods and services) to activity designed purely to minimise 'tax exposure'. The hotels industry is examined below by way of illustrating these problems.

5.12 In other cases, tax expenditure may reward investment that was likely to occur anyway; so-called 'deadweight'. The case of tax credits for energy efficient technology is examined below to illustrate deadweight. This example also highlights that fact that, once created through finance legislation, the decision to extend or expand tax breaks, tax credits or other tax expenditure can sometimes be made by Ministers without the constitutional safeguard of a Dáil vote.

5.13 Crucially, tax expenditure can also undermine the State's revenue base, leaving insufficient funds to provide quality public services.

Use of tax expenditure

5.14 All of the above should make it clear that tax expenditure is neither costless nor risk-free. The weight of evidence suggests that the use of tax expenditure in Ireland has been extreme, and reckless in some cases. Nevertheless, there are reasons to have tax expenditure and, they can be necessary and potentially valuable tools in the public interest.

5.15 The most basic example of necessity is that businesses need to be able to deduct legitimate expenses before declaring profit; otherwise they could be making a loss in real terms yet incurring a tax liability on top of that. The key question is what expenses are 'legitimate' in operating a business. These are defined by the Finance Acts and through rulings made by Revenue.[12] In other areas, providing tax or tax break schemes for productive, socially-useful activity can also benefit the public interest; for example, if firms are encouraged to invest in less environmentally-damaging technology.

5.16 TASC proposed in 2009 that all tax expenditure should be subject to a thorough economic efficiency audit and equality audit, to ensure that measures both benefit the economy and have social benefits that outweigh their costs. The example of tax expenditure on privatised health care is examined below in this context.

Tax expenditure in the Finance Act 2010

5.17 Examples of tax expenditure, on income tax alone, in the Finance Act 2010 include: Section 3 (expands income tax relief to cover the income levy in certain conditions); Section 6 (tax relief on health expenses and nursing home care); Section 7 (extension of mortgage interest tax relief); and Section 20 (age related tax credit). While individual measures can be argued on their merits, it is vital to also consider their effect on the tax system as a whole.

5.18 When tax breaks relate to investment (such as private pension funds, film relief, etc) there is a strong probability that closing one relief will simply lead to investors moving to another one, with little or no increase in tax revenue for the State. Therefore a holistic analysis of the effects of tax expenditure on the tax system as a whole is required, in order to calculate the overall merits and demerits of any particular measure.

5.19 A number of provisions in the Finance Act 2010 are designed to end certain tax expenditure. For example removing tax relief for employers providing art objects to employees, and removing tax relief for service charges (such as local authority waste collection). While the reduction of tax expenditure should boost State revenue, it is

[12] Revenue rulings about legitimate tax expenditures also need to be examined, and should come under the scrutiny of the Oireachtas.

perhaps symptomatic of current policy that a tax relief that benefited over 400,000 households was removed while tax reliefs that benefit a smaller number of high income individuals continue to be supported (such as those for private pensions schemes).

Cost Benefit Analysis of Tax Expenditure

5.20 In commenting on the Budget in 2009, TASC proposed that all current and proposed tax expenditure should be subject to an equality audit and economic efficiency audit. In addition, they should all be subject to an annual check and vote by the Oireachtas, as they constitute a major area of public spending.

5.21 Section 1 of the Finance Act 2010 introduces a new requirement that the Minister for Finance must, within three months, prepare and lay a report before the Dáil giving "...a cost benefit analysis of tax expenditures provided for by this Act, setting out the costs of tax foregone, and the benefits in terms of job creation or otherwise." This provision was a Labour Party amendment that the Government opposed but which was nevertheless passed by the Dáil. The requirement of a cost benefit analysis is a significant advance in setting controls on the cost of new tax expenditure created by the Finance Act 2010 and ensuring accountability for this to the Dáil. The report is due in early July and the detail of its content will show how far it goes towards the equality and economic efficiency audit that TASC has proposed for all tax expenditure (existing as well as new).

5.22 Another recent initiative is the request by the Minister for Finance for all Ministers to report on the effectiveness of tax reliefs granted under their respective Departments. This initiative builds on the recommendations of the 2009 Commission on Taxation report but is not restricted to those areas of tax expenditure where the Commission recommended changes or abolition. This is a useful initiative, which the Minister signalled would be completed by June and which will inform the preparation of Budget 2011 (*Seanad Debate*, Vol. 201. No. 11).

Market distortion (hotels industry)

5.23 One of the major headaches posed by the Finance Acts in recent years is their growing complexity. The proliferation of concessions, definitions, qualifications, etc that have been placed in the legislation has two major negative consequences.

5.24 Firstly, the lack of simplicity and transparency in how the concessions operate effectively discriminates against certain groups. The rules are too complex for individuals or small businesses to be sure how the various provisions operate, so they are required to engage the services of tax consultants. However, for many businesses the cost of engaging tax advice professionals may outweigh the relatively small benefits they might obtain from applying for tax concessions. Hence, larger firms are given a competitive advantage and smaller firms do not benefit.

5.25 The second, and potentially more serious, risk posed by the complexity of the legislation is that it undermines the ability of managers in the private sector to manage their businesses. In theory, managers should be guided by what makes business sense: what goods and services are making money for their business, what innovations look promising, what would add more value, and what do customers want to buy now and into the future. However, complex tax concessions distort the normal operation of markets, sometimes to an extreme. As a result, firms focused on their core business may make less money in the short term than firms that focus on the incentives provided by tax breaks. The endemic tax breaks in the Irish tax system foster a situation where firms can in certain situations make more money by maximising their use of tax concessions than they can from pursuing their original core business.

5.26 A textbook example of this is the hotel industry, where there are now too many hotels and a large over-supply of rooms. 15,000 rooms – a quarter of them – need to be closed according to a report by Dr Peter Bacon commissioned by the Irish Hotels Federation. Tax breaks were successful from the 1960s in growing the industry, in tandem with tourism, but rather than extending the tax break in 1994, the Government should have ended it.

5.27 What occurred during the building and development boom was that hotels were built on the basis of the valuable tax break – which covered 100 per cent of capital costs over seven years – rather than a sound business plan. The report into the hotel industry in 2009 showed that no hotel built since 2005 has been profitable, despite a massive rush to begin hotel projects before the scheme was discontinued in 2006 (Bacon 2009). When ending the scheme was seriously flagged in 2004, there were three times as many planning applications for hotels as 2000 as developers rushed to avail of the tax break.

Distortion in banking

5.28 The market distortion caused by hotel tax breaks extended to the banking system. It is currently better business sense for banks to keep 'tax break hotels' open, despite their lack of long-term sustainability, because if the hotels close the banks are at risk of writing off the large debts incurred when they were built. Simultaneously, previously viable hotel businesses find it more difficult to get working credit from the banks. These long-standing businesses are being undermined by the 'tax break hotels', which can compete at cost levels way below what a sustainable hotel can offer.

5.29 All this goes to show that the production of goods and services, and hence the generation of sustainable jobs in Ireland, requires managers to focus on production, innovation, product development and added value of goods and services. When management is focused on minimising its tax 'exposure', then all of its firm's vital functions are weakened.

Distortion in the property market

5.30 Market distortion is also apparent in other areas of the Irish economy. For example, area-based and property-based tax incentives were in no small part responsible for the unsustainable boom in property prices (for example, as shown by the Indecon and Goodbody reports in the appendices to Budget 2006) and this has resulted in hundreds of thousands of vacant housing units across the State, often in so-called 'ghost estates'. Meanwhile, ordinary families have large mortgages tied to housing that has lost a great deal of its market value ('negative equity'). The market-distorting effect of tax breaks cannot be underestimated.

Deadweight (energy-efficient technology)

5.31 There is a clear need to change our economy in fundamental ways that reflects the reality of limited natural resources, energy insecurity and the scientific arguments for global heating and climate change, which are beyond reasonable doubt. In the long-term, this requires that we reconsider consumption as the basis for economic activity, but in the short-term, there may be time to move to cleaner technologies or technologies that are more energy efficient.

5.32 This was the intention of measures introduced in the Finance Act 2008, Section 44, which provide accelerated capital allowances for investment in energy-efficient equipment. Section 44 extends the relief for another three years and from seven to ten categories, including refrigeration and cooling systems.

Dáil scrutiny of tax expenditure

5.33 The original capital allowance scheme for energy-efficient equipment was to last for three years and covered three areas: motors and drives, lighting and building energy management systems. Section 46 of the Finance Act 2008 also gave the Minister for Communications, Energy and Natural Resources the power to make and amend the list of qualifying criteria and qualifying equipment. This tax relief is not unusual in this respect, as primary legislation typically lays out a skeleton framework and secondary legislation (that is, regulations signed by the Minister) fleshes out the details. However, for all tax reliefs, this means that the Minister can expand the scope of the tax relief – and hence the cost to the Exchequer in revenue forgone – without a vote in the Oireachtas. Elected members can still ask questions, but in effect, tax relief bypasses the constitutional provision that all expenditure of public money must be voted on by the Dáil.

5.34 It is easy to see how Ministers could be enticed or persuaded to expand tax relief schemes beyond their original boundaries, especially if such an expansion could lead to investment or employment in the short-term. This is part of the reason for 'diffusion' of tax breaks and their sometimes higher-than-predicted costs. Hence, it is all the more important to have impartial analysis of the costs and benefits of these schemes, as well as accountability to the Dáil, which has the role of scrutinising the expenditure involved and ensuring the long-term public interest and whole economy is served by them.

Energy-efficient equipment

5.35 There is a specific risk of diffusion and unintended consequences in the tax allowances for energy-efficient equipment. The lack of caps or maximum use of the scheme could lead to a higher cost than initially predicted (and hence inefficiency in terms of the economy and State revenue).

5.36 The intent of the measure would appear to be to give firms an incentive to change over to more modern, energy efficient systems. As this type of machinery is expensive, and consumes a lot of energy, there is an argument for the State to provide an incentive to help firms adopt this technology more quickly. As well as tax relief, firms benefit from lower energy costs and the State should benefit from reduced energy demand. Reduced energy demand in turn should lessen Ireland's energy insecurity problem and reduce strain on the energy infrastructure (power stations, transmission systems, etc). The relief is given as a 100 per cent capital allowance, so the whole cost of purchasing equipment can be written off against tax. Because there is no limit to this, large firms could purchase a great deal of equipment and write it off against tax. This means that large firms, including multi-national corporations, could use the capital allowance to subsidise the set-up costs for industrial installations. The risk of 'deadweight' is that some of this investment would occur anyway and does not require a subsidy.

5.37 One particular example of this relates to 'server farms' – which are, essentially, warehouses holding hundreds of computers, which host websites or other files on the Internet, or which are required for part of the high-tech computer industry, such as 'cloud computing'. Energy efficient computers are obviously desirable on that scale to reduce costs. Also, servers heat up as part of their normal operation and so expensive air conditioning needs to be installed. The problem with this is that there are good reasons for believing that these server farms would be built in Ireland anyway, without any need to provide a tax incentive. As such, the State is likely to lose revenue by providing this tax credit (that is, there may be 'deadweight' in the tax incentive scheme).

5.38 A report for HM Revenue on a similar scheme operating in the UK found that "the deadweight proportion of the CO_2 saving could account for at least 25% of the total savings" and furthermore it was not possible to guarantee that any 'real' CO_2 saving was due to the measure (Experian, 2008: 7).

5.39 One reason why deadweight in this scheme is likely to occur in Ireland is because software firms already located in Ireland require the close geographical proximity of server farms for some of their work. Another reason is that Ireland has a natural climate advantage, in so far as the temperature is rarely excessively hot or cold. Hence, the operating cost of air conditioning is less in Ireland than it would be if the server farms were located in other countries, including major centres like Silicon Valley in California.

5.40 Not only does the extension of this tax relief scheme to large-scale industry mean lost revenue for the State, but the high level of electricity usage by these warehouses may not be fully planned. Hence, it could place strain on power stations, distribution, etc and lead to the unintended consequence of an increase in energy consumption, despite the intent of the tax expenditure to Ireland's consumption of electricity. Hence, this kind of tax expenditure requires caps and maximum use limits.

5.41 It would appear that the level of review given to the sometimes large-scale expenditure through tax relief is less than the strict cost-benefit analysis which applies to capital expenditure by Government Departments or other State bodies. TASC's call for an economic efficiency and equality audit would require all tax expenditure to be more strictly reviewed to minimise the risk of increased costs through 'diffusion' and 'deadweight'.

Inequality and inefficiency (privatised health care)

5.42 Government policy for a number of years has been to support privatised health care, through a range of measures, including planned hospital co-location. However, what is less often analysed is the extent to which tax expenditure underpins the economic rationale of privatised medicine. For example, Section 6 of the Finance Act 2010 continues in this vein and tidies up a range of tax reliefs to do with private medicine. It is beyond the scope of this report to present a full equality audit and economic efficiency audit of these measures; however, the example of privatised health care clearly shows the need for such audits.

5.43 Reliance on tax breaks as the basis for health care clearly fosters inequality in our health system. Tax breaks favours high income people who will benefit more from the breaks and who can afford to spend more on health care. In addition, previous Finance Acts gave generous tax relief to the construction of private hospitals (terminated in 2009). This distorts the cost-benefit comparison of private health provision and public provision, as these private centres are benefitting from the equivalent of State expenditure through tax subsidy, which is also a public cost.

5.44 Looking at the bigger picture of using tax breaks to support private hospital co-location, combined with tax breaks for medical expenses, there seems to be a clear intent to reinforce a three-tier health system. On one level the State supports those on very low incomes through the medical card scheme, and on another level the State supports higher earners through generous tax breaks on medical expenses. In the middle, ordinary households struggle to pay health insurance or do not have adequate (or any) health insurance.

Subsidies to private medicine

5.45 The Commission on Taxation 2009 reported that tax relief on medical insurance cost €321 million in 2008 and tax relief on health expenses cost €167 million in 2006. The latest data in each case is for a different year, but a tentative total cost of around €500 million in any one year is suggested.

5.46 In relation to medical insurance, the Commission identified "a sizeable deadweight element as many individuals would pay these premiums in the absence of tax relief" (2009: 258-259). The Commission proposes retaining the relief, but capping the amount that can be claimed per individual "regardless of the level of cover purchased by the individual" (2009: 259). Their proposal implies that some individuals were gaining disproportionately – presumably those able to afford more expensive medical insurance cover.

5.47 In relation to health expenses, the Commission noted that "tax relief for health expenses may give rise to the costs of some treatments being higher than they might otherwise be in the absence of the relief" (2009: 259). This suggests an element of market distortion. The Commission also notes "the relief is of no benefit to individuals on low income levels who have no income tax liability" (2009: 259).

5.48 Not only do these two tax reliefs constitute State expenditure of around €500 million, but this spending disproportionately goes to higher earners. The State also pays the cost of the medical card scheme, which is a major part of €2.8 billion allocated for community schemes in 2010. (The Revised Estimates for 2010 now combine the cost of all community schemes, so the cost of the medical card scheme cannot be determined separately). In the middle, many households benefit from neither a medical card nor major tax relief. This is a clearly inequitable system.

Universal care

5.49 The move to provide medical cards to all over-70s was an example of moving to a universal public health system (albeit only for older people), which shows that universal public health care does not automatically mean higher costs. The attempt to roll back the measure and introduce means testing was accompanied by the argument that 95 per cent of people over-70 would still be entitled to the card. In that case, it seems probable that tax relief on the health insurance of the remaining five per cent could cost more (or not significantly less) than 100 per cent cover – although it might have negatively impinged upon the insurance industry. In addition, if older people use medical cards to avail of health services more regularly, this is likely to reduce the cost to the public health system of treating more chronic illnesses

5.50 Uniquely in Europe, most 'private' care (i.e. paid by health insurance) in Ireland is given in public beds in hospitals. In effect, this allows patients with insurance to skip the queue, while those dependent on the public health system must wait longer. A further, unintended public 'subsidy' of health insurance comes from the fact that in many cases public hospitals are unable to charge the insurance companies for this care, due to technical difficulties in determining 'bed designations'.

5.51 Overall, there is significant evidence that health policy is seriously deficient. For example, the Irish Medical Organisation (IMO), which is the representative body for doctors, passed a number of critical motions at its 2009 AGM, including that "The IMO has no confidence in the Government's current health policy" (www.imo.ie). This level of criticism is a clear signal that something may be seriously wrong. Reliance on tax breaks to boost health insurance and private medicine generally seems highly inequitable and economically inefficient.

Chapter 6: Foreign Direct Investment and Job Creation

Foreign Direct Investment

6.1 Another essential piece of background information to understanding the Finance Act, and the efficiency or inefficiency of tax expenditure, is the importance of foreign direct investment (FDI) to the Irish economy. As will be discussed below, many of the tax provisions in the Finance Act 2010 are about making Ireland attractive for this investment.

6.2 There are two flows in FDI. Firms (and individuals) based in Ireland invest outside of the country, and investors from other countries invest in Ireland. In 2008, direct investment out of Ireland was €9.2 billion, and foreign direct investment into Ireland was €13.7 billion (CSO, *Foreign Direct Investment*).[13] These flows of investment add (or subtract) from 'stocks' of investment in Ireland, which were valued at €121 billion in 2008, and stocks in other countries (built up from flows from Ireland), which totalled €123 billion.

Productive investment

6.3 Traditionally, investment is understood to mean spending on something productive in the economy. Examples include tangible things like factory buildings or machinery. This kind of productive investment is technically termed 'fixed asset formation'. Such investment yields benefits over time. However, not all FDI is linked to productive investment, in the sense of investment in factories or other infrastructure. FDI can represent the flow of investment money through Ireland for tax purposes. And the evidence is that most FDI does not result in fixed asset formation.

6.4 Evidence for the lack of productive investment comes from a recent report. It is noted that the entire private sector in Ireland (domestic as well as MNCs) invested a "pitiful" €17 billion in core "productive buildings, equipment and new technologies" between 2000 and 2008 (DAVY February 2010, *Irish macro comment*). That represents just over €2.1 billion per year. DAVY also notes the important role of the State in investing in strategic infrastructure.

6.5 If an average of only €2.1 billion per year is invested in productive assets, what does the bulk of the €13.7 billion FDI in 2008 represent? TASC is concerned that a large proportion of FDI moving in and out of Ireland as a financial hub does not represent productive investment and will not lead to long-term sustainable economic development or job creation.

[13] Figures rounded to one decimal place.

International finance

6.6 Ireland has certainly benefited – in terms of jobs and tax paid here – through productive investment by MNCs, which is visible in large industrial production centres that have located in Ireland, for example in pharmaceuticals and software. However, in some cases MNCs declare their profits in Irish subsidiaries for tax purposes, which often employ small numbers of employees or even none. Tax is duly paid on these profits, if this cannot be avoided, and the capital then flows out again. This type of activity can give the appearance of economic activity, but it involves a loss of tax revenue for another country and it does not generate significant employment in Ireland.

6.7 There is a lot of different activity involved in FDI flows, but in part they illustrate that Ireland has become a major conduit for international finance. This was obviously the intent behind the creation of the International Financial Services Centre (IFSC) in Dublin. Ireland is now one of a small number of countries that is a major financial hub for moving money in the global economy. Others include the Netherlands and Luxembourg in the EU, as well as the City of London. Outside the EU, Hong Kong, Singapore, the USA and Switzerland are also major financial centres for the movement of capital, as are offshore centres such as the Bahamas and Cayman Islands.

6.8 As a result, the sources and destinations of the flow of foreign direct investment in and out of Ireland are not surprising. The stock of FDI out of Ireland went to many countries, but the main destinations over time have been the UK (€37.5bn), the USA (€17.5bn), Luxembourg (€13.5bn), the Netherlands (€6.5bn) and offshore centres in Central America (€8.5bn). FDI stocks in Ireland also have come from a wide variety of countries, but the main sources were the Netherlands (€31.5bn), Luxembourg (€26bn), the UK (€12.5bn), Canada (€9bn), the USA (€9bn) and offshore centres in Central America (€11bn).[14] Some of these countries (for example, the Netherlands) may represent conduits for money from US or other multi-national corporations rather than being the location of the investor.

6.9 When examining the Finance Acts, a crucial question is whether provisions to attract FDI are likely to attract productive investment and employment, or merely facilitate the flow of money through Ireland for accounting and tax avoidance purposes.

Tax avoidance and regulatory arbitrage

6.10 Alongside attracting some productive FDI, Ireland has received negative coverage internationally for its tax policies, and the extent to which it facilitates tax avoidance and regulatory arbitrage. For example, the US Government Accountability Office produced two reports in 2008 that illustrate clearly how Ireland is perceived in relation

[14] Figures rounded to the nearest €500 million.

to international finance. In an August 2008 report to the Senate Committee on Finance, Ireland is listed among countries where US subsidiaries pay relatively low levels of effective taxation (US GAO, August 2008). And in a December 2008 report to members of Congress, Ireland is listed as one of 38 countries identified as a tax haven or financial privacy jurisdiction (US GAO, December 2008).

6.11 Of the 100 largest publicly-traded US corporations, Ireland hosts subsidiaries of nearly half (47) of them. In a number of cases, Ireland hosts multiple subsidiaries for the same parent company and is host to a total of 208 subsidiaries of the above 47 corporations. To put this in context, out of the 38 listed tax havens/financial privacy jurisdictions, only three have more of the 100 largest publicly traded US corporations than Ireland (namely Hong Kong 54, Bermuda 53 and Singapore 48) and only four have more subsidiaries from the corporations than Ireland (namely Cayman Islands 571, Hong Kong 238, Luxembourg 237 and Bermuda 229). It should be noted that 17 of these top 100 US corporations do not have any subsidiaries in a country identified as a tax haven/financial privacy jurisdiction (US GAO, August 2008).

6.12 Ireland has adopted a number of features akin to countries that are definitely tax havens. For example, the Finance Act 2010 mirrors the common practice of tax havens that firms do not have to report their accounts in the local currency. Similarly, Ireland's financial laws permit countries to use alternatives to domestic accountancy standards, which is also a feature of tax havens. Many of the provisions in the Finance Act seem to assume that companies have a complex corporate structure, involving holding companies, etc. This appears to be designed for the benefit of multi-national corporations.

6.13 There is substantial evidence to verify that Ireland is a major part of the global financial system for reasons of tax avoidance and regulatory arbitrage. It could be claimed that Ireland is now an essential part of tax planning for most multi-national corporations. For example, an international tax planning company has published details of the 'Double Irish', a method by which US companies can set up a subsidiary in Ireland to double their 'tax savings' while reducing the amount of tax collected worldwide. They comment favourably on the weak regulatory culture in Ireland which facilitates this tax avoidance (WorldTrade Executive, 2007).

6.14 The Finance Act 2010 includes measures that seem more likely to attract non-productive FDI than major job creating industries; for example, measures explicitly designed to make it easier for 'hedge funds' to locate in Ireland, which involve complex financial products that are almost a form of gambling in global markets. It is not at all certain that this will lead to major investment in fixed assets or significant employment.

Tax harmonisation

6.15 In an EU context, there are likely to be moves in the medium-term towards increasing tax harmonisation. Major EU economies such as France and Germany have lost revenue to Ireland because firms producing goods and services declare their profits through Irish subsidiaries. Although Ireland gains through increased corporation tax, the EU economy as a whole loses. And Ireland is highly dependent on a strong EU economy. Calls for tax harmonisation by major EU states have cited Ireland from the outset.

Economic strategy

6.16 TASC argues that there is an urgent need to re-examine Ireland's tax policy, and strategy of attracting FDI, from the perspective of economic efficiency and equality. No tax haven economy ever generated sufficient tax revenue to provide high quality public services. And a central feature of the kind of investment attracted by tax avoidance is that it does not generate significant levels of employment. Reliance on non-productive FDI will not generate anything like as many jobs as we require. One stark example of this is an Irish subsidiary of NCR Corporation which recorded pre-tax profits of €142.3 million for 2005, including royalty income which benefited from significant tax breaks, yet the subsidiary only employed 31 people in Dublin (*Irish Examiner*, 27 November 2006).[15]

6.17 Ireland's need to move away from reliance on foreign direct investment was described by a senior economic advisor to Barack Obama and former US Under-Secretary of Commerce for Economic Affairs, Dr Robert Shapiro as the need to "wean itself from dependence on Foreign Direct Investment". He argued that foreign direct investment – and by implication the tax avoidance measures that Ireland uses to attract a great deal of this investment – "is a transitional strategy, not an end game strategy." He argued for Ireland to develop its domestic economy (*UCD News*, 8 November 2008).

6.18 In May 2009, US President Obama signalled a 'crackdown' on US multi-nationals using tax shelters abroad. Supporting documentation from the US Treasury identified Ireland as a corporate tax haven. Some commentators have suggested that President Obama's announcements in this area were only for domestic consumption in the USA. However, there is a real risk that Ireland's economic future is vulnerable if our over-reliance on US or other foreign direct investment is curtailed by stronger regulation in other countries.

6.19 The measures in the Finance Act 2010, Section 42, to regulate 'transfer pricing' can be seen as recognition that Ireland was becoming increasingly isolated in the world of international finance. In simple terms, these provisions prevent companies selling

[15] http://archives.tcm.ie/irishexaminer/2006/11/27/story19274.asp

goods and services to their own branches and subsidiaries at above or below market prices. The pressure to comply with the standards of our trading partners shows the risks for Ireland in trying to 'have it both ways'. If there continues to be significant tightening of global or EU rules in relation to tax avoidance (and there are many good reasons for this to occur) then Ireland's economic model will be seriously affected. It makes much more sense to plan now for a diverse economy, with stronger indigenous industries. In addition, the domestic banking crisis has shown (in hindsight) the other benefits of stronger financial regulation.

The jobs crisis

6.20 The scale of the jobs challenge is immense, with 267,400 people unemployed in the fourth quarter of 2009, which is just under 100,000 more than one year previously (CSO, *Quarterly National Household Survey*). The seasonally-adjusted live register in January 2010 was 434,700 people, which includes other people, such as those in part-time work, as well as those who are unemployed. The risk is that this level of unemployment could persist, leading to 'jobless growth' for many years to come.

6.21 A large number of people who left construction will need to retrain in order to work in different industries. Many of them left education early in order to work during the boom period, which leaves them at a further disadvantage.

6.22 Unemployment leads to increased State expenditure on social welfare, but decreased State revenue through income tax and consumption taxes. The jobs crisis should be seen as central to Ireland's financial problems and solutions to this crisis should involve supports to small and medium firms as well as large corporations, supports for new product development and innovation, supports for education and training, and development of industries that build on Ireland's natural advantages.

6.23 Much of what Government can do to foster job creation involves expenditure or the re-prioritisation of allocations to different Government Departments. But the Finance Act – as a tool available to Government – could also be used to boost job creation. For example, a general rolling back of tax expenditure would reduce the distorting effect on markets, and let innovation and value-added activity take precedence. Some tax incentives could be useful – if they pass an economic efficiency and equality audit – such as tax relief for investment in the re-skilling and up-skilling of redundant workers, especially from construction, who cannot all expect to be re-employed in their original occupations. However, the Finance Act 2010 lacks any major measures that are likely to foster the growth of jobs. While this is not its primary role as legislation, the current economic crisis would suggest that all tools available to the Government to boost job creation should be used.

6.24 The main emphasis of the Finance Act 2010 appears to be on continued promotion of tax expenditures, with the expectation of attracting foreign and domestic investment.

This is a good example of where the goals of the economy need to be reassessed. If the goal is simply growth for growth's sake, then attracting investment may increase economic growth statistics like GDP, but if sustainable employment at a decent wage is the goal, then the indicator of success is very different and national policy needs to be focused on achieving that aim.

6.25 Ireland is attractive for investment for other reasons, including the English language, membership of the EU and eurozone, quality of life and the education of its workforce. These incentives should also be developed and strengthened as part of Ireland's bid for productive foreign investment, and the use of tax expenditure should be subject to strict equality and economic efficiency audits. While some of the these elements go beyond the scope of the Finance Act, nevertheless a broader jobs strategy requires that the Finance Act include measures that complement such aims.

Diversity in the economy

6.26 A general observation is that successful economies are, on the whole, diverse. They produce a variety of goods and services, across different sectors. Within this, they strike a balance between indigenous enterprise and investment by multi-national corporations. A diverse economy has employment and investment across a wider range of sectors, with a balance between them so that there is no over-reliance on one or two areas of activity. This is good for many reasons, but one key reason is that a diverse economy is better insulated against recession, market changes and global economic impacts. This is particularly salient for Ireland today, as a diverse economy would be less likely to see the kind of mass unemployment that Ireland has experienced with the downturn in construction, and likewise a diverse economy would provide a more resilient tax base for State revenue.

R&D Tax Credits

6.27 One example of a potentially useful way of creating jobs through the Finance Act is the support given for research and development (R&D). The main way in which R&D is currently supported in Ireland is through tax credits, which are in practice oriented towards large corporations, especially MNCs. The Finance Act 2010, Section 54 provides further tax relief for R&D, and Section 55 provides tax relief for certain royalties. The way in which the R&D tax credit works seems unlikely to greatly benefit small and medium indigenous firms because the credit assumes that firms are profitable, and hence can off-set investment against tax liabilities. However, smaller firms that are breaking even will not be able to benefit. Hence, alternative supports for R&D by smaller firms are also required if Ireland is to generate a stronger, indigenous production sector.

6.28 Tax credits for R&D could lead to job growth and were successful in generating significant employment in Denmark in the 1990s. But, in their current form, these credits are unlikely to have significant benefit for job creation, especially by domestic small and medium enterprises. Once again this brings the focus onto the Finance Act. The detail of these provisions not only matters, but it is vital to fine-tune tax measures in order to maximise the benefits to the economy and society in order to support a model of R&D support from innovation through to sustainable employment. Tax credits for R&D provide a good example of why TASC's call for an economic efficiency audit and equality audit of all tax breaks is so important. It is necessary to ask what firms are being supported and the benefit of tax credits (versus the cost of the tax forgone) needs to be measured in the level of new products and sustainable employment that result from them.

6.29 The current R&D tax credit regime has led to mixed results. In some cases, R&D tax credits can be a valuable assistance to firms (small as well as large) which have innovative ideas and need help to get these ideas from conception into the market as goods and services; for example, some pharmaceutical companies in Ireland employ significant numbers of graduates and post-graduates, and this industry is a major source of exports for Ireland.

6.30 Conversely, in other cases, the tax credits appear to simply position Ireland as a conduit through which multi-national corporations can pass their R&D expenditure or patents earnings, in order to benefit from Ireland's tax regime. In exchange, Ireland gains an increase in tax revenue from the presence of these firms, but no significant level of employment is generated here and new products are not being developed in Ireland. This is a long-term weakness in this strategy.

Diverse supports needed for R&D

6.31 Beyond tax credits, there is a need for the State to have a model of support to R&D focused on the pathway from innovation to sustainable employment. This must include an examination of education at all levels, as well as the availability of capital to fund innovative ventures.

6.32 The structure of the current R&D tax credit covers 'process R&D', which is the work involved in getting the product from the laboratory into the factory. This enables firms to claim an R&D credit in respect of production equipment which will also have a much greater useful life making products. In effect the tax relief is focused more on providing an EU-compliant replacement for grants. The State's Tax Strategy Group (chaired by the Department of Finance) has a paper outlining the case for R&D tax credits in 2003 (TSG03/15). This paper seems to portray R&D tax credits as a substitute grant system to attract investment by MNCs. In the short-term, this is entirely valid, as some MNCs employ a considerable number of people in Ireland and it makes sense to encourage them to locate here. But there are also long-term considerations that require a different approach to R&D; for example, are education (especially maths and science) and scientific research being fostered in Ireland at a more fundamental level, which will lead to long-term innovation and more sustainable job-growth, including among indigenous industries?

6.33 Tax breaks in isolation are clearly insufficient to ensure that Ireland participates in the high-value knowledge-based economy and long-term, sustainable employment. An economy reliant on MNCs and FDI can only emerge from recession by growing exports and/or attracting further inward investment. In the context of a global recession, there is plenty of evidence that global demand and foreign investment are likely to remain low. Hence, it is necessary for Ireland to develop its domestic economy as part of its recovery strategy including a more diverse, internationally traded domestic sector, as well as investing in infrastructure and education in order to be well positioned to participate in any global upturn.

Bibliography

Official Documents

Official documents are available in hard copy from the Government Publications Office, but they are also more conveniently available online.

The Finance Act and related documents are available from:

- The Department of Finance <www.finance.gov.ie>
- The Houses of the Oireachtas <www.oireachtas.ie>

Previous finance legislation is available from:

- The Department of Finance <www.finance.gov.ie>
- The Irish Statute Book <www.irishstatutebook.ie>

Exchequer Returns, Estimates for Public Services, Budget and Economic Statistics, Pre-Budget Outlook, etc are available from the Department of Finance <www.finance.gov.ie>

Revenue provides technical documents giving the Revenue's view of legislation, which are available as statements of practice, tax briefings and e-briefs <www.revenue.ie>.

Statistics

Central Statistics Office <www.cso.ie>

Eurostat <epp.eurostat.ec.europa.eu>

OECD, including *OECD Fact Book 2009* <www.oecd.org/ireland>

References

ACCI (4 February 2010) 'Transfer Pricing Rules in 2010 Finance Bill Welcomed'. American Chamber of Commerce in Ireland. <http://www.amcham.ie/article.aspx?id=675>

Bacon, Peter & Associates (November 2009) *Over-Capacity in the Irish Hotel Industry and Required Elements of a Recovery Programme*. <http://www.ihf.ie/press/documents/HotelStudyFinalReport101109.pdf>

Commission on Taxation Report 2009 <www.taxcommission.ie>

Central Statistics Office (November 2009) *Foreign Direct Investment*. <http://www.cso.ie/releasespublications/documents/economy/current/fdi.pdf>

Bergin, Adele, Thomas Conefrey, John Fitz Gerald and Ide Kearney (May 2009) *Recovery Scenarios for Ireland*. Dublin: ESRI. Research Series Number 7.

Callan, Tim, Claire Keane and John R. Walsh (2009) *Pension Policy: New Evidence on Key Issues*. Dublin: ESRI.

Eurostat (2009) *Taxation trends in the European Union*. <http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-DU-09-001/EN/KS-DU-09-001-EN.PDF>

Experian (May 2008) *Evaluation of Enhanced Capital Allowance (ECA) for Energy Saving Technologies*. HM Revenue & Customs with HM Treasury & Defra. Her Majesty's Revenue and Customs Research Report 54. <http://www.hmrc.gov.uk/research/report-54.pdf>

Fitz Gerald, John (October 2009) *Fiscal Policy for Recovery*. Working Paper No. 326. Dublin: ESRI. <http://www.esri.ie/UserFiles/publications/20091019143620/WP326.pdf>

US GAO (August 2008) *U.S. MULTINATIONAL CORPORATIONS— Effective Tax Rates Are Correlated with Where Income Is Reported*. US General Accounting Office.

US GAO (December 2008) *INTERNATIONAL TAXATION— Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions*. US General Accounting Office.

Goodbody (2005) *Review of Area-Based Tax Incentive Renewal Schemes*. Prepared for the Department of Finance.

Goodbody (October 2009) *Irish Economic Commentary*.

Indecon (2005) *Review of Property-Based Tax Incentive Schemes*. Prepared for the Department of Finance.

Kenny, Mr. Justice J. (1974) *Committee on the Price of Building Land, Report to the Minister for Local Government, Robert Molloy*.

OECD (2009a) *OECD Economic Surveys: Ireland*.

OECD (2009b) *Survey of Investment Regulation of Pension Funds*. <www.oecd.org/dataoecd/30/34/2401405.pdf>

OECD (2009c) *Pensions at a Glance*.

O'Sullivan, Pat (2007) *The Wealth of the Nation: How Ireland's wealthy will invest in the next decade*. Bank of Ireland Private Banking.

Sustainable Government Indicators <www.sgi-network.org>

TASC (December 2009) *Budget Response*.

TASC (December 2009) *Pre-Budget Statement*.

TASC (2009) *The H.E.A.P. Chart - Hierarchy of Earnings, Attributes and Privilege Analysis*.

TASC (January 2010 – updated) *Making Pensions Work for People*.

US Government Accountability Office (August 2008) *U.S. MULTINATIONAL CORPORATIONS—Effective Tax Rates Are Correlated with Where Income Is Reported*.

US Government Accountability Office (December 2008) *INTERNATIONAL TAXATION— Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions*.

WorldTrade Executive (15 May 2007) *Practical US/International Tax Strategies.* A Twice-Monthly Report on US/International Tax Planning. Volume 11, Number 9. <http://www.gowlings.com/resources/PublicationPDFs/Hejazi_Hill_IntTaxMay07.pdf>