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Parliamentary Budget Office

# Tax Expenditures in Ireland: Key Issues for Consideration

Briefing Paper 13 of 2018

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# Executive summary



Tax expenditures represent a non-trivial cost to the Exchequer, with total revenue foregone under tax expenditures approximating 10% of total tax revenue for 2016 (the latest year for which data is available). Despite this, once enacted, tax expenditures are not subject to regular parliamentary debate and scrutiny (unlike direct voted expenditure).

This necessitates a routine review of tax expenditures to ensure that they remain fit for purpose, are cost effective, and do not outlive their usefulness. In this way, there is scope for a more in-depth consideration of tax expenditures as part of the wider Budget scrutiny process.

In the context of this Briefing Paper, the PBO emphasizes four key messages:

- **Key message 1 – defining the benchmark system:** consideration might be given to establishing a definitive list of benchmark measures and tax expenditures that are in effect in Ireland. At present, there are discrepancies between the Revenue Commissioners and the Department of Finance regarding the classification of measures as tax expenditures;
- **Key message 2 – costing tax expenditures:** consideration might be given to alternative methods of estimating the costs of tax expenditures, given the underlying weakness inherent in the standard revenue foregone method. Although the PBO acknowledges the complexities of this approach, as an alternative, the final revenue foregone approach which incorporates behavioural effects and the interaction of different policy measures might be considered;
- **Key message 3 – data accessibility and transparency:** consideration might be given to improving the access, availability and transparency of data on tax expenditures. The PBO recognises that, in this instance, there is a need to strike a balance between data transparency and the administrative burden this may place on taxpayers. Nevertheless, consideration might be given to consolidating the data provided by the Revenue Commissioners and the Department of Finance in respect of the cost of tax expenditures (following on from *PBO Key Message 1*). Furthermore, consideration might be given to the publication of the aggregated cost of tax expenditures for each year, and to the publication of the estimated cost of tax expenditures for the year ahead (on an individual and aggregate basis); and,
- **Key message 4 – systematic review and evaluation:** consideration might be given to a systematic approach to the routine review of all tax expenditures. The Department's (and the Commission on Taxation's) own guidelines around tax expenditure evaluation might be enforced. This would involve systematic *ex ante* reviews of all tax expenditures to assess their appropriateness and planned implementation (and the likely data requirements for sufficient *ex post* analysis), and timed *ex post* analysis of their effectiveness and success in implementation.

# Introduction



This Briefing Paper examines tax expenditures in Ireland and specifically, how tax expenditures are defined, costed and reviewed, and emphasises certain key issues in respect of each of these three areas. It further provides an overview of three existing tax expenditure reviews and highlights certain forthcoming reviews.

The paper is structured as follows:

- **Section 1** offers a primer on tax expenditures;
- **Section 2** describes and explains the benchmark tax system;
- **Section 3** examines the approach to costing tax expenditures and assesses the scale of tax expenditures in Ireland;
- **Section 4** outlines the approach to the review and evaluation of tax expenditures in Ireland;
- **Section 5** outlines three existing reviews of tax expenditures and highlights forthcoming reviews;
- **Section 6** provides some concluding remarks; and,
- the **Appendix** contains the impact of changes to select tax expenditures as indicated in Revenue's pre-Budget 2019 Ready Reckoner.

# A primer on tax expenditures



Tax expenditures are a form of government intervention that can be used to correct market failures that result in inefficient or inequitable outcomes. These measures can be designed to encourage a socially optimal allocation of resources.[1] Generally, tax expenditures exploit the existing tax structure to reduce aggregate tax revenue by providing for a reduction in the liability of a subset of payers.

### Box 1: Tax expenditures and externality effects

Externalities arise when the producer or consumer of an economic activity does not fully internalise the costs or benefits associated with that activity. For example, while individual investment in education brings benefits to wider society (positive externalities in the form of reduced crime, and a more educated electorate, for example) these benefits may not feature in the individual's decision-making process. This can lead to under-investment in education from a societal perspective. In this case, Government may intervene to encourage an optimal level of investment in education from the societal perspective (by incentivising individual educational attainment in the form of tax-relief in respect of third-level fees, for example).

Tax expenditures are also politically appealing – they allow governments to privilege a subset of tax-payers without increasing direct expenditure. In particular, these measures can result in a fiscal illusory effect, where taxpayers misperceive the tax burden, and misinterpret tax expenditures as a tax cut rather than a spending increase.[2] In addition, tax expenditures may pose less of an administrative burden than direct spending programmes (which require active programme management and payment distribution). Furthermore, they offer a reduced risk of fraud, given that they can only be availed of by those who are already tax compliant.

However, tax expenditures can give rise to rent-seeking behaviour[3], as the individual benefit granted to a subset of taxpayers tends to outweigh the individual cost, with aggregate costs spread among the remainder of the tax base. In this way, special interest groups (the beneficiaries) may be better motivated (via financial gain) and better organised to canvass in respect of a tax expenditure than the remainder of the tax base (the benefactor).

By their design, tax expenditures represent a departure from the equity principle of taxation, and can create horizontal inequities (whereby a taxpayer can avail of tax expenditures to reduce their liability while another in the same economic position cannot) or vertical inequities (with differential treatment of taxpayers at different economic positions).
By privileging a subset of the tax base, and providing benefits in the form of a reduced tax liability, tax expenditures benefit those who pay the largest amount of tax.

1 *The Commission on Taxation Report (2009) also advises that tax expenditures may be appropriately used to attract inward investment or to offset public policy shortcomings.*

2 *Report on tax Expenditures: Incorporating Department of Finance Guidelines for Tax Expenditure Evaluation, Department of Finance 2014.*

3 *In this context, rent-seeking behaviour describes a situation in which special interest groups lobby political representatives for their own financial gain.*

In addition, there are concerns that tax expenditures contribute to a narrowing of the tax base. As part of their Country Specific Recommendations for Ireland in 2018 (and in previous years), the European Commission have called for a limit to the scope and number of tax expenditures.[4] Intuitively, the greater the number of exemptions or reliefs that apply in respect of a particular tax, the greater the rate of that tax that is required to achieve the same targeted yield.

**Box 2: Legislative definition of tax expenditures**

Tax expenditures are defined in secondary legislation (*S.I. No. 508/2013*) as a:

> "transfer of public resources that is achieved by: (a) reducing tax obligations with respect to a benchmark tax rather than by direct expenditure, or (b) provisions of tax legislation that reduce or postpone revenue for a comparatively narrow population of taxpayers relative to the tax base."

This definition was proposed by the *OECD,* and the *Commission on Taxation* recommended that it be adopted in the Irish context.

4 *European Commission Country Report Ireland 2018.*

# The benchmark tax system



Tax expenditures are defined and costed relative to a benchmark tax system. The OECD defines this benchmark as comprising: "the rate structure, accounting conventions, the deductibility of compulsory payments, provisions to facilitate administration and provisions relating to international fiscal obligations."[5] The Commission on Taxation also refer to the necessity of certain relieving measures or exemptions for the efficient or equitable functioning of the tax system.

While tax expenditures typically take the forms identified in Table 1 – allowances, rate reliefs, exemptions, credits and deferrals are also an intrinsic part of the benchmark tax system. Essentially, benchmark measures are those reliefs/credits/exemptions etc., that are considered (whether for equity or efficiency reasons) to be an intrinsic part of the wider benchmark tax system, and are therefore not classified as tax expenditures. A tax expenditure is considered to exist in the event that a measure causes the tax system to deviate from this benchmark.

### Table 1: Types of tax expenditures

| |
|---|
| **Allowances** |
| Deductions from the benchmark to arrive at the tax base |
| **Rate reliefs** |
| Reduced rate of tax applied to a class of taxpayers |
| **Credits** |
| Deductions from tax liability |
| **Deferrals** |
| Delayed payment of tax |
| **Exemptions** |
| Exclusions from the tax base. |

*Source: Compiled by the PBO.*



5 *Tax Expenditures in OECD Countries*, OECD 2010.

The Commission on Taxation Report[6] identifies 130 benchmark measures, across five categories:

(1) Those that are inherent in the design of the tax system (including the avoidance of double taxation and compliance with international obligations) and those that facilitate administration;

(2) Those related to the unit of taxation and measures that are tax neutral;

(3) Deductions in respect of expenses incurred in earning income;

(4) Measures related to the State; and,

(5) Awards by the Court and compensation payments.

### Box 3: The Commission on Taxation

The Commission on Taxation was established in February 2008, and was tasked with reviewing the efficiency, structure and appropriateness of the tax system in Ireland. Among the terms of reference of the Commission, was a commitment to "review all tax expenditures with a view to assessing the economic and social benefits they deliver and to recommend the discontinuation of those that are unjustifiable on cost/benefit grounds." The Commission published the results of their analysis in the *Commission on Taxation Report* in September 2009. In their report, the Commission recommend that the principles of efficiency, stability and simplicity be adhered to in the design and implementation of tax expenditures.

- **Efficiency**: responsive and capable of being revised, refocused or ended in light of changing circumstances;
- **Stability**: clearly defined with respect to a set objective with a specific period of time;
- **Simplicity**: accessible and transparent, with clarity around the costs and benefits to the Exchequer, and a proportionate administrative and compliance burden.

The definition of the benchmark system varies substantially across jurisdictions, making international comparison extremely difficult. However, there is also a lack of consensus in the Irish context regarding which measures should be classified as belonging to the benchmark system. For example:

- measures relating to relief in respect of double taxation;
- single and married persons tax credits;
- relief in respect of medical insurance premiums;
- exemptions relating to the spousal transfer of property; and
- the provision of additional credits to widowed persons, and deductions in respect of maintenance payments to separated spouses,

are all published by Revenue in a list entitled "Cost of Tax Expenditures (Allowances, Credits, Exemptions and Reliefs)"[7] yet are considered to form part of the benchmark system by the Commission on Taxation.

6 *The Commission on Taxation Report (2009) also advises that tax expenditures may be appropriately used to attract inward investment or to offset public policy shortcomings.*

7 *Revenue Commissioners Cost of Tax Expenditures, 2018.*

Adding to this uncertainty, there is also inconsistency between those measures identified as belonging to the benchmark system by Revenue and the Department of Finance. For example, while the Department of Finance considers personal income tax credits to be a part of the benchmark system, Revenue includes personal income tax credits in the "Costs of Tax Expenditures (Allowances, Credits, Exemptions and Reliefs)".

**PBO Key Message 1 – defining the benchmark system:** consideration might be given to establishing a definitive list of benchmark measures and tax expenditures that are in effect in Ireland. At present, there are discrepancies between the Revenue Commissioners and the Department of Finance regarding the classification of measures as tax expenditures.

# Costing tax expenditures



Unlike direct expenditure measures, tax expenditures do not involve the direct payment of funds from the Exchequer. Rather, tax expenditures are costed in terms of the revenue that is foregone as a result of their implementation, with respect to the benchmark tax system. The OECD[8] describes three approaches to measuring tax expenditures:

- **Initial revenue foregone**: the reduction in tax revenue upon introduction of the tax expenditure, assuming no behavioural change nor interaction effects with other measures;
- **Final revenue foregone**: the reduction in tax revenue upon introduction of the tax expenditure, with assumptions around behavioural change and interaction effects with other measures;
- **Outlay equivalence**: the equivalent direct expenditure required to achieve the same after-tax effect on taxpayer income.

The Department of Finance adopts the initial revenue foregone method,[9] as described above. It is important to note that, as the initial revenue foregone approach to costing tax expenditures does not factor in behavioural responses or the interaction of different measures, it cannot be assumed that the abolition of a tax expenditure will generate a revenue amount that is equal to the estimated cost of that tax expenditure.

Tax expenditures represent a non-trivial and often non-visible cost to the Exchequer. As shown in Table 2 overleaf, total revenue foregone under tax expenditures was approximately 10% of total tax revenue for 2014, 2015 and 2016. Critically, once enacted, tax expenditures are not subject to regular parliamentary debate and scrutiny, unlike direct voted expenditure. This necessitates a routine review of existing tax expenditures to ensure that they are, and remain, cost effective.



8 *Tax expenditures in OECD Countries*, OECD 2010.

9 *Report on tax Expenditures: Incorporating Department of Finance Guidelines for Tax Expenditure Evaluation*, Department of Finance 2014.

### Table 2: Scale of tax expenditures

| | 2016 | 2015 | 2014 |
|---|---|---|---|
| Cost of tax expenditures (€ billions) | 5.02* | 4.17 | 4.73 |
| As a % of total tax revenue | 10.47% | 9.11% | 11.43% |
| As a % of total voted expenditure | 8.98% | 7.64% | 8.91% |
| As a % of GDP | 1.84% | 1.59% | 2.42% |
| As a % of GNI* | 2.86% | 2.58% | 3.18% |

*Source: Compiled by the PBO using the Department of Finance's Annual Report on Tax Expenditures 2015, 2016 and 2017, and the Revenue Commissioners' Cost of Tax Expenditures publication. Only those measures that are considered to be tax expenditures by the Department of Finance have been included (excluding for example, personal income tax credits and other benchmark measures). GDP and GNI* data is obtained from the Central Statistics Office (CSO), while total tax revenue and total voted expenditure data is obtained from the Department of Public Expenditure and Reform's statistical database.*

*Note: * Data for the cost of tax expenditures in 2016 is incomplete – data for some of the largest tax expenditures has yet to be released. The 2016 figure is based on the available data, with figures for 2015 substituted for certain larger tax expenditures that are currently unavailable for 2016.*[10]

**PBO Key Message 2 – costing tax expenditures**: consideration might be given to alternative methods of estimating the costs of tax expenditures, given the underlying weakness inherent in the standard revenue foregone method. Although the PBO acknowledges the complexities of this approach, as an alternative, the final revenue foregone approach which incorporates behavioural effects and the interaction of different policy measures might be considered.

10 *For example, data for tax expenditures relating to: employer and employee contributions to approved superannuation schemes, employer's contributions from employee benefits-in-kind and pension contributions are not yet available for 2016 and have been supplemented in Table 2 using 2015 figures.*

# Framework for reviewing tax expenditures in Ireland



## Commission on Taxation Report 2009

The need for a regular evaluation of tax expenditures has been emphasised by the European Commission[11], the OECD[12], the IMF[13] and the Commission on Taxation[14].

In their 2009 report, for all future tax expenditures, the Commission on Taxation recommended that there should be:

- An ***ex ante* evaluation process** in advance of decisions to implement or extend any tax expenditure, including an assessment of the costs and benefits of proposals and consideration of the alternative of a direct expenditure approach;
- **Better measurement and data collection on the costs and benefits** associated with the introduction or extension of the tax expenditure and the review of its impact;
- **Publication of an annual tax expenditures report** by the Department of Finance as part of the annual budget process and subject to Oireachtas scrutiny[15];
- **Spending through the tax system should be controlled** by, for example, the imposition of thresholds and ceilings and reductions in the rate at which tax relief is given, or in the quantum of a base figure to which tax relief might apply.

Figure 2 overleaf illustrates the Commission on Taxation's recommendation regarding the decision to introduce a tax expenditure, while Figure 3 overleaf outlines the Commission's recommended approach to tax expenditure design and implementation. Generally, the Commission recommends that a tax expenditure be considered only in the event that: (1) it is determined that direct expenditure is not a more appropriate intervention, (2) the proposal adheres to the principles of efficiency, stability and simplicity, and (3) a departure from the equity principle can be justified. In the design and implementation of a tax expenditure, the Commission recommends that policy and impact analysis is carried out, and that there is engagement with stakeholders.



11 *Tax expenditures in direct taxation in EU Member States, European Commission, 2014.*

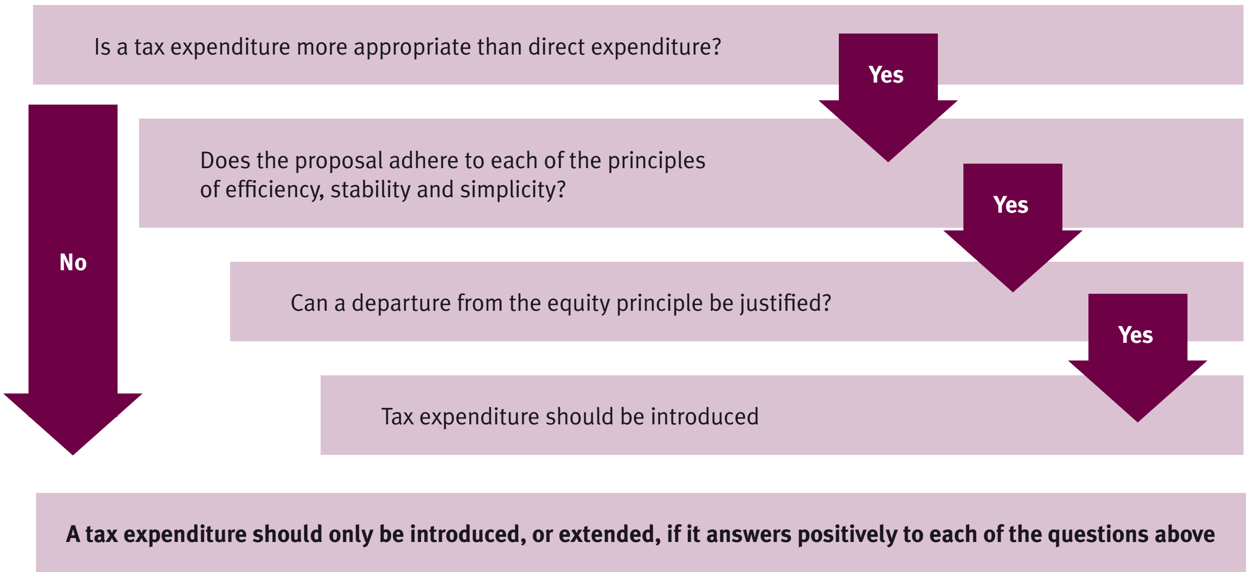
12 *Tax expenditures in OECD Countries, OECD 2010.*

13 *2017 Article IV Consultation Ireland, 2017.*

14 *The Commission on Taxation Report 2009.*

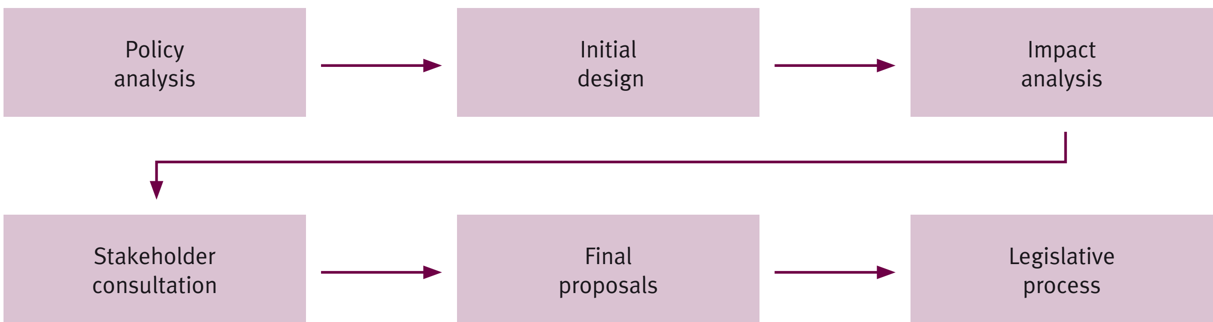
15 *This report was first published by the Department of Finance in 2015, with subsequent reports in 2016 and 2017.*

**Figure 2: Deciding to introduce a tax expenditure**




*Source: Adapted from The Commission on Taxation Report 2009.*

**Figure 3: Path to introducing a tax expenditure**




*Source: Adapted from The Commission on Taxation Report 2009.*

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## Data access and availability

The EU Directive on requirements for budgetary frameworks of the Member States (*2011/85/EU*) was transposed into Irish law by statutory instrument (*S.I. No. 508/2013*). The legislation adopts the OECD definition of a tax expenditure (as recommended in the Commission on Taxation Report 2009, and detailed previously in Box 1) and commits to the annual publication of detailed information on the impact of tax expenditures on revenues.

The Revenue Commissioners is the most comprehensive source for data on the cost of tax expenditures in Ireland, providing annual data by individual tax expenditure. In addition, costings are provided in the Department of Finance's annual tax expenditure reports which have been published annually since Budget 2016 (providing data from 2014, with limited data from 2013). However, given the discrepancy (as highlighted previously) between Revenue and the Department in defining tax expenditures, it is difficult to infer from the available data the aggregate cost of tax expenditures in Ireland.

In a 2014 report, the European Commission identified[16] that 19 EU Member States regularly publish documents relating to tax expenditures. Ireland was among seven Member States classified as providing non-regular publications, however, it should be noted that since the publication of this European Commission report, the Department of Finance has published a Report on Tax Expenditures for 2015, 2016 and 2017 (as referenced throughout this paper). Of those 19 Member States classified as reporting regularly on tax expenditures, 14 had a national legal requirement to do so. There is no commitment in legislation to a regular review of tax expenditures in Ireland, and the EU Directive does not specify a procedure or approach to the evaluation of tax expenditures.

**PBO Key Message 3 – data accessibility and transparency:** consideration might be given to improving the access, availability and transparency of data on tax expenditures. The PBO recognises that, in this instance, there is a need to strike a balance between data transparency and the administrative burden this may place on taxpayers. Nevertheless, consideration might be given to consolidating the data provided by the Revenue Commissioners and the Department of Finance in respect of the cost of tax expenditures (following on from *PBO Key Message 1*). Furthermore, consideration might be given to the publication of the aggregated cost of tax expenditures for each year, and to the publication of the estimated cost of tax expenditures for the year ahead (on an individual and aggregate basis).

16 *Tax expenditures in direct taxation in EU Member States, European Commission, 2014.*

### Box 4: International Reporting Practices

Of those Member States that regularly report on tax expenditures, there are some common features across reporting practices, as identified by the European Commission:

- Reporting is typically carried out on an annual basis, by the Ministry of Finance, the Ministry for the Economy or the tax authorities, or by services reporting to one of these;
- Some Member States publish tax expenditure figures together with other budget documents, as specified in national law, while others publish them as individual reports;
- The reports generally use the 'revenue foregone' method for calculating tax expenditures, but there are significant differences in methodology, for example, whether revenue is estimated on a cash or accruals basis. The time period covered by the reports and the categorisation of tax expenditures used varies greatly. Similarly, some countries' reporting is backward-looking and others' forward-looking;
- Tax expenditures are most often identified in reference to their tax category or tax base (e.g. VAT, personal income tax and corporate income tax), but this type of categorisation is also routinely combined with other categorisations. Expenditures are often grouped according to the type of tax measure (e.g. allowances, rate relief or exemptions), the purpose (e.g. supporting low-income earners or reducing the tax on certain types of housing) or the sector (e.g. households, businesses or agriculture);
- Some countries also link tax expenditures to the expenditure side of the budget;
- Some Member States, where reports on tax expenditures are produced on an annual basis and accompany the budget, send their reports to the national Parliament for examination and discussion (e.g. Belgium, Denmark, Germany, Greece, Spain, France, Austria, Portugal and Finland).

*Source: Tax expenditures in direct taxation in EU Member States, European Commission, 2014.*

## Approach of the Department of Finance to the review and evaluation of tax expenditures

There is no legal requirement to review tax expenditures in Ireland, however, following on from the recommendations made in the Commission on Taxation Report 2009, in “A Strategy for Growth, Medium-Term Economic Strategy 2014-2020”[17], the Government commits to:

- Support economic growth by ensuring any tax increases be effected in the first instance by base broadening through the elimination or curtailment of overly-generous, poorly targeted or otherwise unaffordable tax reliefs;
- Use the tax system in limited circumstances where there are demonstrable market failures and where a tax-based incentive is more efficient than a direct expenditure intervention;
- Time-limit all tax expenditures and subject those with higher costs to *ex ante* evaluation;
- Conduct a regular programme of tax relief reviews using public consultation as appropriate and publish results.

Furthermore, the Department of Finance published guidelines on the evaluation of tax expenditures[18] in October 2014. In these guidelines, the Department outlines its approach to tax expenditure evaluation. These are reproduced in Table 3 below. In addition, the criteria for evaluating tax expenditures (*ex ante* and *ex post*), as described by the Department are reproduced in Table 4 overleaf.

### Table 3: The Department of Finance’s approach to *ex-ante* and *ex post* evaluation in respect of tax expenditures

| ***Ex-Ante*** **Evaluations** | ***Ex-Post*** **Evaluations** |
|---|---|
| 1. What objective does the tax expenditure aim to achieve? | 1. Is the tax expenditure still relevant? |
| 2. What market failure is being addressed? | 2. How much did the tax expenditure cost? |
| 3. Is a tax expenditure the best approach to address the market failure? | 3. What was the impact of the tax expenditure? |
| 4. What economic impact is the tax expenditure likely to have? | 4. Was it efficient? |
| 5. How much is it expected to cost? | |

*Source: Report on tax Expenditures: Incorporating Department of Finance Guidelines for Tax Expenditure Evaluation, Department of Finance 2014.*

17 *A Strategy for Growth, Medium-Term Economic Strategy 2014-2020*, October 2014.

18 *Report on Tax Expenditures: Incorporating Department of Finance Guidelines for Tax Expenditure Evaluation*, Department of Finance 2014.

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**Table 4: The Department of Finance's criteria for tax expenditure evaluation**

| Estimated Annual Cost | Level | *Ex Ante* | *Ex Post* | Time Limit/Review |
|---|---|---|---|---|
| Between €**1m and €10m** | Level 1 | *Ex ante* assessment and identification of criteria for *ex post* evaluation | Application of *ex post* criteria | Five years to review |
| Between €**10m and €50m** | Level 2 | Detailed assessment – scenario based analysis or similar and statement of proposed methods and data requirements for full ex post cost-benefit analysis (CBA) | Full *ex post* CBA | Five years to trigger review<br><br>Interim review after three years if annual costs exceed €25m |
| Greater than €**50m** | Level 3 | Full *ex ante* CBA and statement of methods and data requirements for full *ex post* CBA<br><br>Use of pilot scheme if possible | Full *ex post* CBA | Interim review after three years |

*Source: Report on Tax Expenditures: Incorporating Department of Finance Guidelines for Tax Expenditure Evaluation, Department of Finance 2014.*

In their review of tax expenditures, the Commission on Taxation identified 258 tax expenditures and reviewed 241 of these. Of the tax expenditures reviewed, the Commission recognised 130 of these as being part of the benchmark system. It further recommended that 31 of the remaining 111 tax expenditures be discontinued, 33 be modified and 47 continue as normal.

As mentioned previously, for Budget 2016, Budget 2017 and Budget 2018, the Department of Finance published an annual report on tax expenditures, detailing the annual (and previous year) cost alongside reviews of select tax expenditures that were carried out in the preceding twelve months. However, under the Department's own guidelines for tax expenditure evaluation, several reviews are over-due or are due in the next twelve months. While not an exhaustive list, based on the reviews already completed and the Department's own guidelines on the timing of reviews (as well as on the available public information on reviews that were promised), an evaluation of the following tax expenditures might be considered within the next year:

- The **R&D Tax Credit** (last reviewed in 2016, cost €670 million in 2016);
- **CAT Agricultural Relief** (last reviewed in 2014, cost €140.5 million in 2017, a review on the implementation of recommendations that arose from the 2014 agri-taxation review in general is due to be complete in Q3 2018);
- **Film Relief** (last reviewed in 2012, cost €87.6 million in 2015);
- **Employment and Investment Incentive** (last reviewed in 2014, cost €32.6 million in 2016, a review alongside the Start Up Relief for Entrepreneurs was due to take place throughout 2018[19]);
- **Start Your Own Business Relief** (cost €19.6 million in 2016, a review is underway[20] with the incentive due to expire on 31 December 2018);

19 *Income Tax and Universal Social Charge, Tax Strategy Group, Department of Finance, 10 July 2018.*

20 *Ibid.*

- **Certain tax reliefs that support business** e.g. exemption of Employers' contributions from employee BIK (never reviewed, cost €559 million in 2015, the Minister for Finance indicated that a review of the BIK treatment of motor vehicles would be carried out in 2018[21]), Allowable Expenses (never reviewed, cost €85 million in 2016, a general review of income tax expenditures that support business was carried out in 2014); and
- **Home Renovation Incentive** (cost €113m from October 2013 to March 2018, a review is underway[22] with the incentive due to expire on 31 December 2018).

In addition to the above, the PBO notes that the 2016 annual report on the Special Assignee Relief Programme (SARP), and the review of the Section 482 Relief (*consultation initiated in February 2017*), have yet to be released.

**PBO Key Message 4 – systematic review and evaluation:** consideration might be given to a systematic approach to the routine review of all tax expenditures. The Department's (and the Commission on Taxation's) own guidelines around tax expenditure evaluation might be enforced. This would involve systematic *ex ante* reviews of all tax expenditures to assess their appropriateness and planned implementation (and the likely data requirements for sufficient *ex post* analysis), and timed *ex post* analysis of their effectiveness and success in implementation.

21 *Dáil Éireann debate, Wednesday 22 November 2017.*

22 *Ibid.*



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# Existing reviews



## Economic evaluation of the R&D tax credit, October 2016

A firm's investment in research and development (R&D) activities provides external benefits to third-parties in the form of knowledge spill-overs. As firms do not internalise the full extent of the benefits from R&D activity, they may under-invest in R&D from a societal perspective. The R&D Tax Credit is an attempt to counter this underinvestment by incentivising firms to carry out additional R&D activity.

A company can qualify for the R&D Tax Credit subject to the following *criteria*[23]:

- The company is within the charge of Corporation Tax in Ireland;
- The company carries out qualifying R&D activities in Ireland or the European Economic Area (EEA);
- The expenditure does not qualify for a tax deduction in another country;
- The R&D activity involves systemic, investigative or experimental activities in the field of science or technology; and,
- The R&D activity involves at least one of the following categories – basic research, applied research, experimental development, scientific or technological advancement, the resolution of scientific or technological uncertainty.

The R&D Tax Credit was introduced in *Finance Act 2004*. It provides for a 25% refund of qualifying R&D expenditure against the Corporation Tax liability of a firm. Initially, the credit applied to R&D expenditure in excess of the firm's level of R&D expenditure in a base year. However, substantial changes have been proposed or made to the R&D Tax Credit since its introduction (a summary of these is provided in Box 5 overleaf), including the removal of the base year restriction. The Commission on Taxation advised against this move to a volume-based scheme, noting that the incremental expenditure approach provides an incentive to companies to increase their levels of R&D spending, and reduces the Exchequer and deadweight costs associated with the scheme. As shown in Table 5 below, the cost of the scheme has risen substantially in recent years, increasing by over 170% from 2011 to 2015. The cost in 2016 (the latest year for which data is available) is €670m (a 5% drop relative to 2015).

**Table 5: Cost of the R&D Tax Credit (foregone revenue), € millions, 2011-2016**

| Year | 2016 | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|---|
| **Cost** | 670 | 707.9 | 553.3 | 421.4 | 281.9 | 261 |
| **Y-o-Y Change** | -5% | 28% | 31% | 49% | 8% | – |

*Source: Revenue Commissioners Cost of Tax Expenditures, 2018.*

23 *Revenue website – reliefs and exemptions, September 2018.*

### Box 5: Summary of proposed changes to the R&D Tax Credit

*Budget 2004* – **estimated full year cost of changes: €8 million**: a 20% tax credit was introduced for incremental R&D expenditure in excess of qualifying expenditure relative to the base year of 2003. The tax credit was only available if the total of R&D expenditure was not less than €50,000.

*Budget 2007* – **estimated full year cost of changes: €70 million:** the base year expenditure against which incremental R&D expenditure is measured was fixed at 2003 for a further three years until 2009. The scheme was expanded to include expenditure via the sub-contracting of R&D activity up to a limit of 10% of qualifying R&D expenditure in any one year.

*Budget 2008* – **estimated full year cost of changes: €60 million:** the base year expenditure against which incremental R&D expenditure is measured was fixed at 2003 for a further four years until 2013.

*Budget 2009* – **estimated full year cost of changes: €20 million:** the 20% rate of tax credit was increased to 25%. Allowed for the full discharge of the R&D tax credit over a three year period as an offset against corporation tax or as cash payments in the event of insufficient or no corporation tax.

*Budget 2012* – **estimated full year cost of changes: €4.75 million:** the first €100,000 of qualifying R&D expenditure benefits from the 25% tax credit on a volume basis (that is, without reference to the base year of 2003). The credit continues to apply to R&D expenditure on an incremental basis in excess of €100,000, compared with such expenditure in the base year (set at 2003). The outsourcing limits for sub-contracted R&D costs were increased to the greater of 5% or 10% as appropriate, or €100,000. Companies in receipt of the credit were granted the option to use a portion of the credit to reward 'key employees' who have been involved in developing R&D.

*Budget 2013* – **estimated full year cost of changes: €4 million:** the level of qualifying R&D expenditure that benefits from the 25% tax credit on a volume basis (that is, without reference to the base year of 2003) was increased to €200,000.

*Budget 2014* – **estimated full year cost of changes: €5 million:** the level of qualifying R&D expenditure that benefits from the 25% tax credit on a volume basis (that is, without reference to the base year of 2003) was increased to €300,000. The outsourcing limit for sub-contracted R&D costs was increased to 15% of the total amount of qualifying expenditure on R&D in a given year.

*Budget 2015* – **estimated full year cost of changes: €50 million:** previously the 25% tax credit applied to the amount of qualifying R&D expenditure incurred in a given year that is in excess of the amount spent in 2003. The 2003 base year restriction was removed.

*Note: The above refers to changes as announced as part of the respective Budget, it does not reflect amendments which may have been made to the Finance Bill in each case.*

The R&D tax credit was previously reviewed in 2013[24], wherein it was concluded that the credit was an effective means of incentivising R&D activity at the time. The 2016 evaluation by IGEES assesses if public funding for R&D activity results in extra or additional activity rather than a replacement of in-firm financing with public funds (i.e. deadweight loss).

The evaluation conducts a counterfactual exercise to identify the causal effect of public funding on R&D activity, based on a treatment and control group framework. In doing so, the evaluation exploits a variation in the policy introduced in Budget 2009 (which saw the introduction of a repayable credit) to assess if the credit causes extra R&D activity that would not have occurred otherwise.

Of the R&D conducted over 2009 to 2014, the review estimates that 60% is additional activity (that is, R&D activity that occurs due to the credit) and 40% is deadweight (R&D activity that would have occurred without the credit). In terms of value for money, the review finds that, for each €1 foregone under the R&D Tax Credit, €2.40 is generated in additional R&D activity (out of a maximum of €4). This means the scheme funds some R&D that would have been conducted anyway, implying that public support via the R&D Tax Credit is partially crowding out private funding for R&D. The review concludes that the R&D Tax Credit can be considered a reasonably successful policy tool, in that it stimulates some additional R&D, but with considerable deadweight that should not be ignored.

It should be noted that, under the Department of Finance's own guidelines for tax expenditure evaluation[25], the R&D Tax Credit should be subject to a full *ex post* cost-benefit analysis. The 2016 review notes that it is limited to examining additional R&D activity and value for money, and that a full cost-benefit analysis in the context of the R&D Tax Credit would be onerous and potentially lead to imprecise results. However, given the rising costs of the scheme (a 170% increase in 4 years), and the substantial policy changes that have been made to the scheme in successive Budgets, a full *ex post* cost-benefit analysis of the R&D Tax Credit would be prudent and in-line with the Department's own guidelines on tax expenditure evaluation.

## Review of the Taxation of Share Based Remuneration, October 2016

There are a number of Revenue approved share schemes in Ireland; Approved Profit Sharing Schemes (APSS) including Employee Share Ownership Trusts (ESOT), and Savings Related Share Option Schemes (SAYE). Generally, Revenue approved share option schemes allow the value of the benefit received by an employee to be taxed as a capital gain when the shares are disposed of, rather than as taxable income at the time that the option is granted or shares acquired. More specifically:[26]

- **APSS** involves the allocation of shares by a company to its employees. Subject to certain conditions, there is an exemption from income tax on the value of the shares received. No income tax is charged on the acquisition of the shares by the individual where they are held for a minimum of 3 years. On the disposal of the shares, Capital Gains Tax (CGT) is calculated on the difference between the market value of the shares on acquisition and the proceeds of the sale.

24 *Review of Ireland's Research and Development (R&D) Tax Credit 2013*, Department of Finance, 2013.

25 *Report on Tax Expenditures: Incorporating Department of Finance Guidelines for Tax Expenditure Evaluation*, Department of Finance 2014.

26 *Taxation of Share-Based Remuneration*, Tax Strategy Group Papers, Department of Finance, July 2016.

- **SAYE** involves employees saving for a period of 3 or 5 years under a contractual savings scheme, with a view to purchasing shares in the company allocated under the share option scheme. The maximum monthly savings allowable is €500. The employee is not liable to income tax on the benefit received on acquisition of the shares. On disposal of the shares, CGT is calculated on the difference between the price paid on acquisition of the shares and the sale proceeds.

These schemes are intended to improve the competitiveness of Irish based companies in attracting top talent in the context of a competitive international labour market. In terms of total cost (Table 6 below), tax expenditures relating to share based remuneration experienced a substantial rise between 2015 and 2016 (of 48%). At an estimated €70 million in 2016, this places them comfortably above the Department's own threshold for classification as a level three tax expenditure (see Table 4), requiring full *ex post* cost-benefit analysis and three year interim review.

A review of the taxation of share-based remuneration is contained within the 2016 Tax Strategy Group papers[27]. Unlike the 2016 evaluation of the R&D Tax Credit, this review was limited to engagement and consultation with stakeholders, rather than an empirical assessment of the effectiveness of the scheme. Following this consultation process, the Department considered various options for reform and gave an assessment of its position in respect of these options. These are summarised in Box 6 overleaf.

### Table 6: Cost of tax expenditures relating to share based remuneration (foregone revenue), € millions, 2011-2016

| Year | 2016 | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|---|
| **APSS** | 68.6 | 44.7 | 50.8 | 39 | 57.1 | 25.1 |
| **ESOT** | 1.7* | 1.7 | 1.7 | 1.1 | 0.5 | 2.3 |
| **SAYE** | 3.5* | 3.5 | 3.5 | 3.5 | 1.3 | 2.5 |
| **Total** | 73.8* | 49.9 | 56 | 43.6 | 58.9 | 29.9 |
| **Y-o-Y Change** | 48% | -11% | 28% | -26% | 97% | – |

*Source: Revenue Commissioners Cost of Tax Expenditures, 2018.*
*Note: * ESOT and SAYE figures for 2016 are supplemented using 2015 figures (as data is not yet available for 2016).*

27 *Ibid.*

### Box 6: Options considered as part of the review of the taxation of share based remuneration, and the Department's position in respect of those options

**Potential amendments in relation to the taxation of restricted shares**

In the case of restricted shares, it was noted that a tax liability arises on an award of restricted shares, notwithstanding that the employee cannot sell the shares during the period of the restriction. This reduces the attractiveness of such share awards to employees. Consideration was given to amending the treatment of restricted shares to provide for the income tax liability to be payable on the lifting of the restriction, and also to allow for a more beneficial CGT treatment on any capital gains arising on disposal. However, it proved difficult to estimate a cost for such a measure in view of the lack of statistics available currently on the use of restricted share schemes.

**Develop a SME focussed share based remuneration incentive over the next year**

Reference was made to an SME targeted scheme in the UK (EMI). However, the Department noted that, following the implementation of this scheme in the UK, EU State Aid approval would be required from the European Commission (given that it targets companies of a certain size or type only).

**Increasing the €12,700 annual limit for Approved Profit Sharing Schemes**

In response to requests to raise the annual limit beyond €12,700, the Department emphasised the conditions of the current scheme.

**Amending the requirement for Revenue approved share schemes to be made available to all employees on similar terms**[29]

In response to requests for the APSS scheme to be targeted at certain key employees (rather than the requirement to make the scheme available to all employees on similar terms), the Department highlighted than a previous scheme that allowed for certain targeting of key employees was abolished in 2010, with modest take-up. In addition, the Department highlights that assuming the annual limit of €12,700 remains in place, the attractiveness to employees at levels relevant to key decision making or employment generation would be limited.

**Changes to Reporting Requirements**

The Department states that the review highlights the relatively limited data that is available regarding the prevalence of share base remuneration in Ireland, noting that additional data would help guide decision-making in this policy area.

*Source: Taxation of Share-based Remuneration, Tax Strategy Group Papers, Department of Finance, July 2016.*[28]

28 *The Key Employee Engagement Programme (KEEP) was introduced in Finance Act 2017, and allows certain key employees to defer taxation on receipt of share options until these shares are disposed of.*

## Impact Assessment of the Help-to-Buy Incentive, September 2017

The Help-to-Buy Incentive was introduced in Budget 2017.[29] It offers an income tax rebate to assist first-time buyers of new homes (or self-builds) in funding their deposit under Central Bank macro-prudential rules. The rebate is based on income tax paid over the previous four years up to 5% of the purchase price up to a total maximum purchase price of €400,000. Under the Incentive, applicants are required to take out a mortgage of at least 70%[30] of the purchase price. In limiting the incentive to the purchase of new homes, the scheme was intended to incentivise a supply response to the challenges facing the housing market. The scheme is scheduled to run until the end of 2019 (the scheme has a sunset clause and is due to expire on December 31 2019).

Given that the scheme is relatively new, there is little public information regarding the costs to date. The estimated full year cost of the Help-to-Buy Incentive for 2017 (as stated in Budget 2017) was €50 million. The Department of Finance estimated that the actual cost of the scheme in 2017 was €68.9 million (including €16.7 million in retrospective claims from July to December 2016). The 2018 cost (as of July 2018[31]) is €35.4 million. This means that the total cost of the scheme to date is approximately €104.3 million. Assuming a similar cost for the second half of 2018, and including the Department's estimated cost for 2019 of €40 million, the Help-to-Buy Incentive has the potential to reach approximately €180 million by the end of 2019, when the scheme is scheduled to close.

An ESRI report on tax breaks in the residential property market (summarised in the Department of Finance's Report on Tax Expenditures 2015[32]) concludes that tax incentives aimed at stimulating residential construction should be subject to *ex ante* scrutiny. The report highlights that it is necessary to establish if any such scheme will yield positive results without excessive unintended transfers to developers, and to ensure the impacts of regulations are fully understood. However, this *ex ante* analysis was not carried out in respect of the Help-to-Buy Incentive. In their review[33] of the scheme (summarised in the Report on Tax Expenditures 2017[34]), Indecon also expressed concerns that this *ex ante* review was not carried out.

29 *Revenue website, Help to Buy (HTB) Incentive, September 2018.*

30 *Although initially set at 80%, the Finance Bill was amended and the loan-to-value ratio was set at 70%.*

31 *Response by the Minister to Parliamentary Question 34856/18, 24 July 2018.*

32 *Report on Tax Expenditures 2015, October 2015.*

33 *Indecon Impact Assessment of the Help to Buy Tax Incentive, Indecon, September 2017.*

34 *Report on Tax Expenditures 2017, October 2017.*

The Indecon review notes that the design of the scheme has a number of desirable characteristics, including the time limited nature of the incentive, and the restriction of the scheme to a segment of the market. The methodology applied in the review by Indecon involved:

- An analysis of anonymised microdata from Revenue on transactions supported by the scheme;
- An examination of CSO, Daft.ie and MyHome.ie data on changes in prices in the housing market;
- A detailed survey of contractors approved for the scheme;
- An evaluation of views from stakeholders in the sector;
- The modelling of impacts of the incentive on affordability for different income cohorts;
- An analysis of the correlation between take up of the scheme and changes in new residential property prices by county; and,
- The modelling of the determinants of Irish property prices.

Indecon's assessment suggests that there is no impact on overall prices of new homes for first-time buyers as a result of the measure, and link this to the limited take up of the scheme, and the fact that the incentive was confined to a segregated segment of the market. The review further notes that the scheme does not appear to have had any significant impact on the level of supply, noting the time lag required to construct new houses. It notes that the scheme likely benefitted some purchasers who did not need the incentive, suggesting some degree of deadweight. In particular, since the introduction of the scheme, changes in Central Bank macro-prudential rules have made it easier for some categories of first-time buyers to fund deposits.

The report recommends that a comprehensive cost-benefit analysis of the Help-to-Buy scheme be carried out, to build on this preliminary assessment. The Department of Finance have indicated that this analysis is due to be completed ahead of Budget 2019.[35]

35 *Income Tax and Universal Social Charge*, *Tax Strategy Group, Department of Finance, 10 July 2018.*

# Conclusion



Tax expenditures represent a non-trivial cost to the Exchequer, and yet, are not subject to regular parliamentary debate and scrutiny. There is scope for a more routine review of tax expenditures, as part of the wider Budget scrutiny process, to ensure that they remain fit for purpose, are cost effective, and do not outlive their usefulness.

This Briefing Paper provided an explanatory analysis of tax expenditures in Ireland, with an overview of how tax expenditures are defined, costed and reviewed. It further provided an overview of three existing tax expenditure reviews and identified four key issues for consideration:

- **Key message 1 – defining the benchmark system:** consideration might be given to establishing a definitive list of benchmark measures and tax expenditures that are in effect in Ireland. At present, there are discrepancies between the Revenue Commissioners and the Department of Finance regarding the classification of measures as tax expenditures;
- **Key message 2 – costing tax expenditures:** consideration might be given to alternative methods of estimating the costs of tax expenditures, given the underlying weakness inherent in the standard revenue foregone method. Although the PBO acknowledges the complexities of this approach, as an alternative, the final revenue foregone approach which incorporates behavioural effects and the interaction of different policy measures might be considered;
- **Key message 3 – data accessibility and transparency:** consideration might be given to improving the access, availability and transparency of data on tax expenditures. The PBO recognises that, in this instance, there is a need to strike a balance between data transparency and the administrative burden this may place on taxpayers. Nevertheless, consideration might be given to consolidating the data provided by the Revenue Commissioners and the Department of Finance in respect of the cost of tax expenditures (following on from *PBO Key Message 1*). Furthermore, consideration might be given to the publication of the aggregated cost of tax expenditures for each year, and to the publication of the estimated cost of tax expenditures for the year ahead (on an individual and aggregate basis); and,
- **Key message 4 – systematic review and evaluation:** consideration might be given to a systematic approach to the routine review of all tax expenditures. The Department's (and the Commission on Taxation's) own guidelines around tax expenditure evaluation might be enforced. This would involve systematic *ex ante* reviews of all tax expenditures to assess their appropriateness and planned implementation (and the likely data requirements for sufficient *ex post* analysis), and timed *ex post* analysis of their effectiveness and success in implementation.

# Appendix – Impact of policy changes (Revenue Ready Reckoner, 2018)





| Tax expenditure | Policy change | Details | Full year cost (€ millions) |
|---|---|---|---|
| **Single Person Child Carer Tax Credit** | Increase by €100 | From €1,650 to €1,750 | 3.7 |
| **Home Carer's Credit** | Increase by €50 | From €1,200 to €1,250 | 4 |
| **Dependent Relative Credit** | Increase by €20 | From €70 to €90 | 0.7 |
| **Incapacitated Child Credit** | Increase by €100 | From €3,300 to €3,400 | 2.2 |
| **Blind Persons Credit** | Increase by €500 for Single Person | From €1,650 to €2,150 | 0.6 (combined) |
| | Increase by €1,000 for both spouses/civil partners blind | From €3,300 to €4,300 | |
| **Age Credit** | Increase by €50 for single/widow/surviving Civil Partner | From €245 to €295 | 16 (combined) |
| | Increase by €100 for married/civil partners | From €490 to €590 | |
| **Income Tax Relief on Pensions** | Changes to Income Tax Relief on Pensions | From €115,000 to €120,000 (at existing rate) | -2 |
| | | From €115,000 to €110,000 (at existing rate) | 8 |
| | | From 40% to 39% (at existing ceiling) | 16 |
| | | From 40% to 34% (at existing ceiling) | 96 |
| **CAT Agricultural Relief** | Reduce CAT Agricultural Relief by 10% | From 90% to 80% | 7.7 |
| | Reduce CAT Agricultural Relief by 20% | From 90% to 70% | 18.1 |
| **CAT Business Relief** | Reduce CAT Business Relief by 10% | From 90% to 80% | 8.3 |
| | Reduce CAT Business Relief by 20% | From 90% to 70% | 18.3 |

*Source: adapted from Revenue Ready Reckoner, August 2018.*

*Note: The above Ready Reckoner costings are estimates, and assume no behavioural change from an increase or decrease in taxation.*

Contact: *PBO@Oireachtas.ie*
Go to our webpage: *www.Oireachtas.ie/PBO*
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**Houses of the Oireachtas**
Leinster House
Kildare Street
Dublin 2
D02 XR20

*www.oireachtas.ie*
Tel: +353 (0)1 6183000 or (076) 1001700
Twitter: @OireachtasNews

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