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Third Report
of the
Commission on Taxation

INDIRECT TAXATION

June 1984

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PREFACE

1. This is our third report based on the results of our examination of the Irish tax system under the terms of reference given to us when we were established in March, 1980. These were

“To enquire generally into the present system of taxation and to recommend such changes as appear desirable and practicable so as to achieve an equitable incidence of taxation, due attention being paid to the need to encourage development of the national economy and to maintain an adequate revenue yield; and to provide interim reports on such matters as the Commission considers desirable or as may be referred to it by the Minister for Finance for specific consideration”.

2. This report gives our recommendations on the general system of indirect taxation which should apply in Ireland. The proposals made should be read in conjunction with those in our first and second reports. Our first report outlined a general system of direct taxation which should apply in Ireland. Our second report dealt with the departures from this basic structure which are required to accelerate the development of the national economy. It is the impact of the tax system as a whole which is important for both the citizen and the state. It is, therefore, the total system which should reflect the principles of equity, efficiency and simplicity which have guided us throughout these reports.

3. In preparing this report, we sought specialist advice to supplement the work done by our own secretariat. Mr. Michael O'Connor of the Institute of Taxation gave us the benefit of his research into stamp duties. Mr. John Reilly of the Operations Research Unit of the Department of the Public Service analysed for us some special tabulations from the 1980 Household Budget Survey. Access to the original data was allowed to him by the Central Statistics Office. Professor Muiris FitzGerald of University College Dublin advised us on the implications of cigarette smoking for health. Professor Cedric Sandford of the University of Bath undertook a critical review of the final draft of this report. We are grateful to them for their valuable contribution to our work.

Consultations

4. In the preparation of this report, we received assistance from the Office of the Revenue Commissioners, in particular from officers dealing with customs and excise duties, stamp duties and value-added tax. We also consulted other Government Departments on appropriate matters. We had discussions with a wide variety of interest groups, individuals and organisations, both on a formal and informal basis.

5. The Chairman and Secretary visited the EEC Commission in Brussels to discuss aspects of indirect taxation. Discussions were also held in London with officials of H.M. Customs & Excise and with experts in the field under review. Two meetings were held with the Chairman and members of the Committee on Economic and Monetary Affairs of the European Parliament.

Acknowledgements

6. We again express our sincere thanks to the many individuals and organisations who have helped us in drawing up this report. Many of those who made submissions prior to the first and second reports gave us supplementary information relating to indirect taxation. We hope that the co-operation which we have received will continue until we have finished our work. The Secretariat has again supplied an exceptionally high standard of service to the Commission and we are particularly grateful to the Secretary, Donal de Buitléir, the Assistant Secretary, Paul Reic and the other members for their contribution.

Other Reports

The first two reports dealt with direct taxation and incentives. This report is concerned with indirect taxation. Substantial issues still remain, including the question of administration, and these will be dealt with in a further report.

THE KEY ELEMENTS OF PROPOSED REFORMS

1. This report deals with the system of indirect taxation which we consider should apply in Ireland. Our recommendations complement those made in our first two reports dealing with direct taxation and should be examined as part of a total package. We believe that the system of indirect taxation, which we propose in this report, is very much simpler than the existing system, will contribute to economic progress by being much more efficient and would be consistent with the proposals in our first and second reports.

2. The key elements of the system of indirect taxation we propose are

- (i) value-added tax should be the main source of indirect taxation and should eventually be levied at a single rate on all purchases,
- (ii) the single rate of value-added tax should be very much lower than the existing low rate of 23 per cent,
- (iii) special taxes, mainly excises, should still be levied on a relatively narrow range of goods and activities, such as alcohol, tobacco, motoring and betting,
- (iv) excise duties, once established at a correct level, should be adjusted on a regular basis to take account of inflation,
- (v) when economic management requires a change in indirect taxation, this should normally be confined to the single VAT rate because this is a better method of demand management than sudden increases in selective taxes, and
- (vi) stamp duties should be immediately reformed and ultimately abolished.

3. Some may argue that a single-rate VAT system would be less progressive than a multi-rate system which taxes 'luxuries' more than essentials. We are satisfied that to charge different rates of indirect tax on different goods and services is a most wasteful and ineffective way of trying to redistribute income. That task is best achieved by well-designed public expenditure programmes, supplemented at the top of the range of income

and wealth by a progressive expenditure tax. Measures on the indirect tax side complicate the system, give increased scope for evasion and accomplish little in the way of redistribution.

Value-Added Tax

4. The history of value-added tax in Ireland has echoes of a familiar theme. In 1972 the tax began its life as one levied at reasonably modest and acceptable rates on a wide base. Since then the base has been steadily eroded and the rates of tax on the remaining items have been increased to unacceptable levels. This has increased the pressure for further concessions which are very difficult to resist on any rational basis.

5. VAT has great advantages as an indirect tax. It is efficient in the economic sense: it favours investment and saving relative to consumption as it is levied only on the value added by an enterprise (basically its pay costs and profits); it avoids the distortions to corporate structure implied by many other forms of indirect taxation. It is also the form of indirect taxation favoured by the EEC, and it is now a familiar tax in Ireland which has proven relatively easy to administer. The collection of a high percentage of the total tax from manufacturers and wholesalers reduces the danger of evasion. Except at the retail level, VAT enables the records of taxpayers to be cross-checked. For these reasons we consider that VAT should continue to be the backbone of indirect taxation in Ireland.

6. We believe that it is time to revert to first principles and widen the tax base. The Revenue Commissioners have told us that a rate of 14.4 per cent on all consumption expenditure would produce the same yield as the existing structure of six different rates. They also told us that some allowance should be made for the increased efficiency and better compliance which could be expected under a single rate.

7. We conclude that the objective should be to levy a general value-added tax at a single rate. Considerable savings in administrative and compliance costs arise from reducing the number of different rates of value-added tax and by having one rate applied to all goods and services. The proposed structure would also be more efficient. A general value-added tax levied at a single rate would improve economic efficiency by removing the waste of resources associated with the distortion of patterns of consumption and production. The proposed new structure could also lead to more efficient redistribution. An active social policy of granting welfare benefits to people really in need of them would be much more effective in achieving redistribution than a patchwork of different rates of value-added tax.

Excise Duties

8. Excise duties are duties levied on a particular commodity, usually at an early stage of the productive process and usually expressed as a fixed amount of duty per volume purchased or produced. Common examples are the duties on petrol, drink and tobacco. They are relatively simple to collect but are a much less refined form of indirect taxation than VAT. They impinge, in the first instance, on the productive sector but their final incidence is uncertain and probably varies from one commodity to another. Excise duties have played an important role in Irish taxation and are still high by international standards. The level of individual excises is aggravated by the imposition of VAT on the same commodities because VAT is levied not only on the value of the product but also on the excise duty.

9. Excise duties are discriminatory taxes. However, this attribute can be used to advantage where market prices do not reflect adequately the costs to society of using the particular product. Thus, excises may increase efficiency in the use of resources. Selective taxes (mainly excises) can also be raised or lowered to curb or stimulate demand for certain products in the short term. This may be for balance of payments reasons. However, if excises are raised significantly they can disrupt the industries concerned. Account must therefore be taken, in setting the level of duties, of the effects on the industries themselves and on the tourist business if they are too high and on the general diversion of trade, particularly to Northern Ireland and Britain, if they lead to wide differences in price in the two jurisdictions. Large price differentials give rise to smuggling and other illegal activities. This has even more damaging effects than those arising from trade distortion.

10. The range of excise duties examined includes: alcohol and tobacco, transport, and betting. Different considerations affect the three groups.

Alcohol and Tobacco

11. In principle, we believe that excise duties on alcohol and tobacco may be justified on the grounds that there are significant costs associated with consumption of these products which are not reflected in their pre-tax prices. We have identified the main areas where costs and benefits arise but it is difficult to quantify them with any precision. We recommend that, in determining the excise duties on alcohol and tobacco, account should be taken of the level of VAT and of the need to avoid retail prices in the Republic becoming significantly higher than in Northern Ireland and Britain.

Transport

12. Special taxes on transport may be used to cover the costs of depreciation of the roads and to offset the costs imposed on the community by air and noise pollution, traffic congestion, increased risk of death and injury and other damaging effects of the use of motor vehicles on third parties. They may also be used to regulate imports of new cars.

13. There are three sources of taxation on transport: excise duty on hydrocarbon oils, excise duty on motor vehicles, parts and accessories and motor vehicle duties (commonly known as road tax or car tax). There is room for simplification of this regime. Excise duties on fuel are the most satisfactory form of taxation of motoring. We recommend that the highest possible proportion of special taxes on motoring be collected from this source, subject to the need to prevent the price of petrol in the Republic becoming significantly higher than in Northern Ireland. Excise duties on private cars should be retained but excises on parts, accessories and commercial vehicles should be abolished. The road tax should be simplified by a reduction in the number of rates of duty and the removal of tax from a number of vehicles which are not primarily intended for use on the roads.

Betting

14. The present administration of betting duty is very unsatisfactory and the duty appears to be evaded widely. The rate of duty at 20 per cent is virtually unenforceable. The rate of betting duty should be reduced at least to the level in the United Kingdom and the duty on on-course and off-course bets should be aligned.

Stamp Duties

15. Stamp duties are a relic of the past and are an anachronism in a modern fiscal system. The ultimate objective should be to remove them. However, stamp duties raise significant amounts of revenue, mainly from the purchase and sale of houses and land. (We do not propose that they be ended now but we will consider possible alternatives in a further report). In the interim, we propose a number of reforms which would improve the existing system.

Implementation

16. These proposals represent a substantial programme of tax reform. Our views on how they might be introduced are in Chapter 14. Some of the reforms are urgent and should be introduced immediately. However, in general, we believe that the need for reform of direct taxation is greater. Wherever a choice has to be made between the two, priority should be given to the rationalisation of the existing system of direct taxation.

LIST OF RECOMMENDATIONS

Introduction

The principal conclusion drawn from our review of indirect taxation in Ireland is that there is a great need to simplify the system. The changes we propose would do this and would contribute to economic progress by being much more efficient. Our full recommendations are:

Chapter 5: Structural Aspects of Value-Added Tax

1. The general objective should be to levy value-added tax at a single rate on as broad a base as possible. In the context of this general recommendation we make the following additional recommendations:
2. Expenditure on the following items which are zero-rated, exempt, or charged at special rates should be charged fully to VAT:
 - (i) food,
 - (ii) clothing and footwear,
 - (iii) oral medicine,
 - (iv) electricity,
 - (v) books,
 - (vi) agricultural services, farm accounting and farm management services,
 - (vii) building and associated services, and property transactions already within the scope of VAT subject to a fixed reduction in chargeable value by reference to the unimproved value of sites,
 - (viii) building land subject to a fixed reduction in chargeable value by reference to the unimproved value of land,
 - (ix) passenger transport services,
 - (x) admission to sporting events, and
 - (xi) telecommunications services.
3. Zero-rating or exemption of the following items should be maintained as long as they are compatible with Ireland's obligations to the EEC under the Sixth Directive:

- (i) animal feed stuff, animal oral medicine, fertilisers and seeds (zero-rated),
 - (ii) services supplied by veterinary surgeons (exempt), and
 - (iii) supply of greyhounds and thoroughbred horses (exempt).
4. Expenditure on the following items should continue to be exempt from VAT in accordance with the Sixth Directive:
- (i) education, hospital and medical care,
 - (ii) financial services,
 - (iii) insurance and reinsurance transactions, and
 - (iv) betting (subject to the existing conditions and limitations) and lotteries.
5. Farmers and fishermen should retain the option to register for VAT. Unregistered farmers and fishermen should continue to be compensated for VAT on their purchases by means of a flat-rate addition to the prices at which they sell their produce.
6. The existing restrictions on the right to deduct input tax should be retained subject to compliance with EEC obligations.

Chapter 7: Structural Aspects of Excise Duties

7. Excise duties should be levied at wholly specific rates, subject to compliance with EEC directives in the case of cigarettes.
8. Specific excises should be adjusted automatically on a quarterly basis to take account of the effects of inflation. The adjustment should be made by reference to the increase in the consumer price index in the preceding quarter. When inflation does not reach a minimum level in any quarter, the adjustment should be deferred until the next period.

Chapter 8: Excises on Alcoholic Beverages

9. Excise duties on alcohol may be justified on the basis that they charge the consumer for the external costs imposed on society by the consumption of alcohol. We have identified the main areas where costs and benefits arise, but it is extremely difficult to quantify the net social costs in economic terms. In determining the excise duty on alcohol, account should be taken of the need to prevent the price of alcohol becoming significantly higher in the Republic than in Northern Ireland and Britain.

10. Excises on alcohol should vary only with respect to the alcohol content of different beverages.

11. Subject to due consideration for the structure of the brewing industry, the duty on beer should be levied on a finished product basis.

12. The rebate of excise duty on beer produced by small brewers should be abolished when duty on beer is charged on a finished product basis.

13. All undenatured spirits (i.e. those containing potable alcohol) should be charged to excise duty at the standard rate.

14. Alcohol for medical purposes or for use in any art should continue to be exempt from excise duty.

15. Excise duties on table waters should be abolished.

Chapter 9: Excises on Tobacco Products

16. Excise duties on tobacco may be justified on the basis that they charge the consumer for the external costs imposed on society by the consumption of tobacco. We have identified the main areas where costs and benefits arise, but it is extremely difficult to quantify the net social costs in economic terms. In determining the excise duty on tobacco, account should be taken of the need to prevent the price of tobacco becoming significantly higher in the Republic than in Northern Ireland and Britain.

17. All forms of tobacco should be charged to excises at the same rate, or at equivalent rates where the bases of charge vary.

18. Subject to compliance with EEC directives, excise duties on tobacco should be wholly specific.

Chapter 10: Taxation of Transport

19. Taxes on motoring should cover the depreciation of the road network and the costs imposed on the community arising from motoring in the form of air and noise pollution, traffic congestion and road accidents. These taxes should be imposed on all road users. Further taxes may also be used to regulate imports of private cars and to reduce consumption of energy. These additional taxes should not apply to the traded sector.

20. The highest possible proportion of special taxes on motoring should be raised in excise duties on hydrocarbon oils, subject to the need to prevent distortion of trade between Northern Ireland and the Republic.

21. Some excise differential between petrol and auto-diesel should be maintained while diesel is used mainly for industrial purposes. The existing differential should be reduced. Auto-diesel and LPG should bear the same rate of duty.
22. Leaded petrol should bear a significantly higher rate of excise duty than unleaded petrol.
23. Rebates for diesel used by public transport operators should be withdrawn and replaced if necessary by a direct subvention.
24. Excise duties on motor cars, motor cycles and certain mini-buses (Category 'A' vehicles) should be retained.
25. Excise duties on goods vehicles (Category 'B') should be abolished.
26. Excise duties on parts and accessories, tyres and tubes should be abolished.
27. Road tax on mobile machines, forklift trucks, agricultural tractors, general haulage tractors, excavators, trench diggers and other vehicles not primarily used on the roads should be abolished.
28. The number of different rates of road tax on private cars and motor cycles should be reduced.
29. Road tax on heavy goods vehicles should be related to gross vehicle weight and the number of axles per vehicle.
30. Concessionary rates of road tax for large and small public service vehicles should be continued.
31. The Road Fund should not be restored.

Chapter 11: Betting and Gambling

32. In order to deal with evasion of betting duty, the rate of betting duty should be reduced as a matter of urgency. In any event, the rate of tax on betting should not exceed that charged in the United Kingdom.
33. Tax on off-course bets should be reduced to the level of duty and levy charged on on-course bets. The stamp duty on on-course betting should be abolished. Tax on on-course betting, other than betting levies, should be levied in the form of excise duties.

Chapter 12: Miscellaneous Excises

34. Temporary selective excises on consumer durables should be imposed only when the following criteria are met:

- (i) the goods selected are a significant source of import demand,
- (ii) the imposition of the excises does not result in significant administrative or compliance costs, and
- (iii) the price of goods after imposition of excises should not be such as to encourage diversion of trade to Northern Ireland or give rise to opportunities for smuggling.

35. Excise duties on televisions, videos and records should be revised in line with the criteria in recommendation 34.

36. Excise duties on matches and mechanical lighters should be abolished.

37. The objective should be to charge expenditure on foreign travel to value-added tax as soon as the position in other countries allows this to happen. In the interim, the foreign travel tax could be retained.

38. Excise duties on residual fuel oil used by the ESB and by industry should be removed.

39. Excise duties on hydrocarbon oil used by certain fishermen and horticultural producers should be abolished.

40. Excise duties on domestic heating oil should be removed and such fuels charged to value-added tax.

Chapter 13: Stamp Duties

41. Stamp duties on conveyances of lands, houses and other property, leases, mortgages and settlements should be abolished eventually.

42. Stamp duties on transactions in stocks, shares and other securities should be abolished.

43. Stamp duties on cheques, bills of exchange, promissory notes and on credit cards should be abolished.

44. Stamp duties chargeable on life assurance policies should be abolished.

45. Stamp duties on profits of sweepstakes should be abolished when the

<i>Equity, Tax:</i>	Standards of fairness. The tax payable should accord with ability to pay.
<i>Excise Duties:</i>	Selective taxes imposed on certain goods, the most common being on tobacco, alcohol and petrol.
<i>External Costs:</i>	Costs arising from the production or consumption of goods which are not borne by the producer or consumer of the goods.
<i>Incidence, Effective Tax:</i>	Who ultimately pays a tax as a result of adjustments to economic behaviour after the tax is legally assessed.
<i>Income Distribution:</i>	The way in which total national income is divided among individuals or households.
<i>Indirect Taxation:</i>	That part of total tax revenue collected by means of a levy attached to expenditure or services. Value-added tax and excise duties are the principal sources of indirect taxation.
<i>Neutral Tax System:</i>	A system which does not distort economic behaviour.
<i>Progressive Tax Structure:</i>	A system under which the average rate of tax increases as income rises.
<i>Regressive Tax Structure:</i>	A system under which the average rate of tax falls as income rises.
<i>Sales Tax:</i>	A tax levied on the sale of goods or services.
<i>Simplicity:</i>	A tax structure characterised by comprehensibility and consistency.
<i>Specific Tax:</i>	A tax charged on a unit or volume basis.
<i>Stamp Duties:</i>	Charges imposed on certain written legal and commercial documents.
<i>Subsidy:</i>	A payment or relief provided to producers of goods and services intended to make prices lower than they otherwise would be.

<i>Tax Avoidance:</i>	Arranging one's financial affairs within the law so as to minimise taxation liabilities.
<i>Tax Base:</i>	The object to which the tax rate is to be applied, e.g. income, wealth or consumption.
<i>Tax Evasion:</i>	Failure to meet true tax liabilities through not declaring income, profit, or sales, or claiming allowances to which no entitlement exists.
<i>Value-Added Tax:</i>	A general tax which is applied to all stages of production and distribution of goods and services and levied on the difference in value between sales and taxable inputs.
<i>VAT Exemption:</i>	The absence of a charge to value-added tax on a product or service which does not allow the recovery of tax borne on inputs.
<i>Zero-rating:</i>	The application of a zero rate of value-added tax to a product or service which allows the recovery of tax borne on inputs.

Part I

The Background

CHAPTER 1

INDIRECT TAXATION IN PERSPECTIVE

Introduction

1.1 In this report we are concerned with indirect taxation. Firstly, we examine the justification for indirect taxation. We then set out the latest available information on the level of indirect taxation in Ireland and certain other countries. An outline of the historical development in Ireland of the various indirect taxes is in Appendix 1.

Definition

1.2 The forms of indirect taxation which we consider under this heading include value-added tax, customs duties, excise duties (including liquor and other licences), stamp duties, motor vehicle duties, agricultural levies, broadcasting licence fees (excluding amounts transferred to RTE) and other miscellaneous fees. A comparison of international classifications of tax revenues is in Appendix 2. A list of licences, other than liquor licences, and a list of miscellaneous fees included in the National Income Accounts as taxation is in Appendix 3. We do not propose to examine all of these fees in detail. However, we give our views on the principles which should govern the introduction of fees and the level at which they are maintained.

Justification for Indirect Taxes

1.3 If the revenue demands of the Exchequer reach levels that cannot be met from direct taxation without significantly reducing the incentives to work, take risks, save and invest, then recourse must be had to indirect taxation to raise revenue.

1.4 To preserve equity in the taxation system it is necessary to maintain a reasonable balance between direct and indirect taxation. Some indirect taxes are regressive. However, the fact that an individual tax is regressive does not make it unacceptable as a means of raising revenue. Equity has to be achieved through the impact of the tax and public expenditure system

TABLE 1
International Tax Comparisons OECD Countries 1981 as a Share of Gross Domestic Product

Category ¹	General ² Taxes on Goods and Services	Other Taxes ³ on Goods and Services	Taxes ⁴ on Property	Total ⁵ Indirect Taxes
	%	%	%	%
Industrialised Europe	6.8	4.9	1.6	13.3
Non-Europe OECD	2.3	5.4	2.7	10.4
Less Industrialised Europe	3.6	5.4	1.0	10.0
Ireland	6.0	11.3	1.7	19.0
OECD Average	5.3	5.4	1.8	12.4
EEC Average	6.8	5.1	1.9	13.7
Ireland's ranking amongst OECD countries	11th	1st	10th	2nd
Ireland's ranking amongst EEC countries	7th	1st	4th	2nd

Source: Revenue Statistics of OECD Member Countries (1983 Ed).

Notes:

¹ 22 OECD countries excluding Ireland have been grouped as follows:

Industrialised Europe comprises Austria, Belgium, Denmark, Finland, France, Germany, Italy, Luxembourg, Netherlands, Norway, Sweden, Switzerland and the United Kingdom.

Non-Europe OECD comprises Australia, Canada, Japan, New Zealand and the United States.

Less-industrialised Europe comprises Greece, Portugal, Spain and Turkey.

² The only tax under this heading in Ireland is value-added tax.

³ The taxes under this heading in Ireland are customs and excise duties; excise licences, betting duties, agricultural levies and motor vehicle duties.

⁴ The taxes under this heading in Ireland are stamp duties and rates on property. Wealth tax and taxes on estates, inheritances and gifts are also included.

⁵ This category includes motor vehicle duties paid by households which are usually classified as direct taxes. Also, because of limitations in the data available, it includes taxes on wealth and taxes on estates, inheritances and gifts. In the main these taxes account for less than 1 per cent of gross domestic product.

1.13 The heavy reliance on indirect taxation in Ireland is confirmed by Table 2 which shows the share of total tax revenue in OECD countries accounted for by indirect taxes.

TABLE 2
International Tax Comparisons OECD Countries 1981 as a Share of Total Tax Revenue

Category	General Taxes on Goods and Services	Other Taxes on Goods and Services	Taxes on Property	Total Indirect Taxes
	%	%	%	%
Industrialised Europe	16.5	11.9	4.2	32.6
Non-Europe OECD	7.0	17.1	8.5	32.6
Less industrialised Europe	12.5	20.8	4.2	37.5
Ireland	15.5	29.3	4.5	49.3
OECD Average	13.7	15.3	5.1	34.2
EEC Average	17.3	13.2	4.9	35.4
Ireland's ranking amongst OECD countries	11th	1st	11th	1st
Ireland's ranking amongst EEC countries	7th	1st	4th	1st

Source: Revenue Statistics of OECD Member Countries (1983 Ed).

1.14 Ireland's reliance on indirect taxation is large and is increasing as a proportion of gross domestic product. However, the relative importance of indirect taxes as a share of total tax revenue has declined over the last twenty years because direct taxes have risen even faster. This is shown by Table 3 which reveals the changes in the composition of total tax revenue in Ireland and in the proportion of gross domestic product absorbed by these taxes between 1965 and 1979, together with estimates for 1983 and 1984.

TABLE 3
Structure of Taxation in Ireland

Category	Share of Gross Domestic Product				Share of Total Tax Revenue			
	1965	1979	1983	1984	1965	1979	1983	1984
Personal Income Taxes ¹	%	%	%	%	%	%	%	%
	4.3	9.9	12.9	14.0	16.7	30.0	32.4	34.5
Social Security contributions								
—Employers	0.9	3.0	3.7	3.7	3.3	9.2	9.2	9.2
—Employees	0.8	1.7	1.8	1.8	3.2	5.0	4.5	4.5
Corporation Income Taxes	2.4	1.9	1.5	1.6	9.0	5.7	3.9	3.9
Taxes on Goods and Services ²	13.7	14.8	18.3	18.1	52.7	43.4	46.1	44.6
Taxes on Property ³	3.9	2.0	1.6	1.4	15.1	6.1	3.9	3.3
Total	26.0	33.3	39.8	40.6	100.0	100.0 ⁴	100.0	100.0

Source: Revenue Statistics of OECD Member Countries (1983 Edition) and Department of Finance.

Notes:

¹ These include income tax and capital gains tax. The income levy and the youth employment levy are included in the figures for 1983 and 1984.

² These include value-added tax, excise duties and excise licences, customs duties and agricultural levies (EEC), motor vehicle duties and betting duties.

³ These include stamp duties, rates on property, wealth tax and taxes on estates, inheritances and gifts. The residential property tax is included in the estimates for 1983 and 1984.

⁴ Slight discrepancy due to rounding of figures.

1.15 Table 3 shows that between 1965 and 1984, personal income taxes and social security contributions have increased as a proportion of total tax revenue, while taxes on goods and services, taxes on property and corporation income taxes have all declined as a proportion of total tax revenue. Personal income taxes increased in importance due to rising incomes and, in particular, to the failure to maintain the real value of personal tax allowances and tax rate bands. While these structural changes have been taking place, all the major taxes (personal income tax, social security contributions and taxes on goods and services) have been increasing as a proportion of gross domestic product.

1.16 Table 4 shows the changes in the composition of total indirect taxation in Ireland between 1965 and 1984. The share of indirect taxes in

total tax revenue has declined over the period, although there was a slight increase in 1983. Within this overall trend there was substantial growth in the relative importance of general taxes on goods and services, such as value-added tax. There has been a decline in the relative importance of other taxes on goods and services. Part of the decline is related to entry into the EEC and the consequent dismantling of protective customs duties.

TABLE 4
Structure of Indirect Taxation in Ireland

Category	Share of Gross Domestic Product				Share of Total Tax Revenue			
	1965	1979	1983	1984	1965	1979	1983	1984
	%	%	%	%	%	%	%	%
General Taxes on Goods and Services	1.5	5.7	8.5	8.8	5.7	17.1	21.5	21.7
Other Taxes on Goods and Services	12.3	8.7	9.8	9.3	47.0	26.3	24.6	22.9
—Customs	1.1 ¹	0.6	0.6	0.6	4.2 ¹	1.7	1.4	1.4
—Excises	9.9 ²	7.9	8.4	7.9	38.2 ²	23.7	21.3	19.0
—Other	1.3	0.2	0.8	0.8	4.6	0.9	1.9	1.9
Taxes on Property	3.9	2.0	1.5	1.3	15.1	6.1	4.0	3.4
—Rates	3.2	1.3	0.8	0.8	12.2	3.9	2.0	2.0
—Stamp duties	0.4	0.6	0.7	0.5	1.4	1.7	1.9	1.3
—Other	0.3	0.1	0.02	0.03	1.5	0.5	0.1	0.1
Total Indirect Taxes	17.7	16.4	19.8	19.4	67.8	49.5	50.1	48.0

Source: Revenue Statistics of OECD Member Countries (1983 Edition) and the Department of Finance.

Notes:

¹ This figure represents only the protective duty element of customs, approximately 18 per cent of total customs duties receipts. Prior to 1976 customs duties comprised fiscal duties and protective duties. Under EEC decision (73/200/EEC), the fiscal element was removed from certain customs duties and transferred to excise duties.

² This figure includes excise duties and the fiscal element of customs duties on certain goods.

1.17 Excises have also declined in importance, although they still account for a large share of tax revenue. The share of total tax revenue in Ireland accounted for by excise duties declined from 38.2 per cent in 1965 to 23.7 per cent in 1979. Since 1979 the share of excises increased to 27 per cent in 1981 but declined again to 23 per cent in 1982. A further decline to 21.3 per cent took place in 1983 and it is estimated that excises will account for only 19.6 per cent of total tax revenues in 1984. The overall decline which occurred in the period from 1965 to 1983 is due in the main to the development of new taxes and in particular general taxes on goods and services such as value-added tax. However, another factor which influenced the trends in the share of excises was the rate of increase in the duties compared with the rate of increases in the consumer price index. In the period from 1969 to mid 1983, the specific duties increased at a slower rate

than the consumer price index. However, since 1980 excises have tended to increase at a faster rate than consumer prices. This led to the share of excises reaching 27 per cent in 1981. The decline which took place in 1982 and 1983, despite large increases in excise duty rates in those years, was due mainly to the increase in value-added tax as a share of tax revenue.

1.18 The level of individual excises is affected by the imposition of VAT on the same commodities because VAT is levied not only on the value of the product but also on the excise duty. In effect, the increases over recent years in VAT have effectively increased excises also. Therefore, a comparison of trends and even of levels of different indirect taxes can be misleading where either VAT is at high levels or has been increasing rapidly.

1.19 Property taxes are also less significant now due largely to changes which have taken place in the rating system and to the eventual abolition of rates on domestic property. However, the decline in the share of taxes on estates, inheritances and gifts is also reflected under this heading. Stamp duties on property increased slightly in importance because of the increase in the number of transactions subject to duties during the period and the failure to index the property values subject to higher rates of duty.

Summary

1.20 From this brief review of developments, the following points become obvious. Firstly, by international standards the share of total tax revenue raised in indirect taxation in Ireland is relatively high. Secondly, the structure of Irish taxation has changed considerably during the last twenty years, with greater reliance now being placed on direct taxation than was the case heretofore. Thirdly, the composition of indirect taxation has undergone significant change. A large share of tax revenue is now raised in value-added tax and the share of tax revenue raised in excises has declined. Since VAT is applied to excises, however, the effect of rapid and large increases in the rates of VAT over recent years has been, in effect, equivalent to large increases in excises. Therefore, a comparison of trends and even of levels in different indirect taxes can be misleading where VAT is either at high levels or has been increasing rapidly.

CHAPTER 2

TYPES OF INDIRECT TAXES

Introduction

2.1 In this chapter we outline the main forms of indirect taxation which it is possible to introduce. Most of these exist in Ireland, or did exist before they were replaced by other indirect taxes.

2.2 Indirect taxes are levied on the sales of goods or services. Stamp duties, which are also indirect taxes, are levied on specific legal instruments and on certain financial and capital transactions. Taxes on goods and services may be imposed at various levels — on the manufacturer, the wholesaler or the retailer; in various forms — single and multiple stage; and different exemptions may be provided — such as food and clothing. Taxes on goods and services may be either narrowly-based, falling only on a few consumption goods and services (even if they absorb quite a significant proportion of consumer expenditure) or broadly-based on very large ranges of goods and services.

BROADLY-BASED TAXES

2.3 Broadly-based taxes may take two forms — single-stage taxes or multi-stage taxes. Multi-stage taxes may be operated with or without credit for tax paid at earlier stages, that is, they may be cascade taxes or value-added taxes.

Single-stage Taxes

2.4 Single-stage taxes are those which apply only once to each product or service as it passes through the production and distribution process. These taxes may be applied at

- (i) manufacturing level: this tax is applied to all sales of manufactured goods,
- (ii) wholesale level: this tax is applied to all sales to retailers, whether by manufacturers, wholesalers or importers, and
- (iii) retail level: this tax is applied to the final retail sale to the consumer.

Multi-stage Taxes

2.5 Cumulative or 'cascade' taxes charge transactions up to any of the basic trade levels — manufacturing, wholesale or retail. The pure form of cascade tax applies the full rate of tax to every transaction through which goods pass on their way from the first stage of production to the final consumer. No credit is given for tax paid at earlier stages.

2.6 Value-added tax is applied to all stages of production and distribution. The tax base is the value which is added during each individual stage, that is, sales less the cost of goods and services which were taxed when purchased by the firm. Value-added tax is compulsory in all EEC countries and directives are in force which govern the structure of the tax.

NARROWLY-BASED TAXES

2.7 Narrowly-based taxes are levied on a limited range of goods and services. They take the form of excise duties, motor vehicle duties, customs duties, agricultural levies, stamp duties and miscellaneous fees.

Excise Duties

2.8 Excise duties are selective taxes imposed on certain goods and services. The three most common groups of goods subject to excises are tobacco products, alcoholic drinks and petroleum products. Excises on services include a levy on betting and the imposition of licence fees on a number of activities, including ownership of a dog, gaming and money-lending. A full list of excise licences is in Appendix 3.

2.9 Excises may be specific or *ad valorem*. Specific excises are expressed as a fixed sum per excisable unit. *Ad valorem* excises are expressed as a percentage of unit value or price. Combinations of specific and *ad valorem* rates are sometimes used.

Motor Vehicle Duties

2.10 Motor vehicle duties (commonly known as road tax) are levied in respect of the use of vehicles in public places or on public roads. The tax is a fixed annual charge levied on the basis of engine horsepower (or cubic capacity) in the case of private cars¹ and on the basis of unladen weight in the case of goods vehicles.²

¹ Motor vehicle duties paid by households are classified as direct taxes in the National Income Accounts, whereas duties paid by businesses are treated as indirect taxes.

² All motor vehicle duties are collected through local authorities as agents for central government.

Customs Duties

2.11 Originally there was a distinction between customs duties which were imposed on imports and excise duties which were levied on home-produced goods and services. This distinction is no longer made in Ireland. Today, duties levied for revenue purposes are known as excise duties and are charged on both home-produced and similar imported goods. Duties for protective purposes are called customs duties and these are levied under the EEC Common Customs Tariff. This means that Ireland, like the other members of EEC, now operates a common tariff on imports from non-member countries while trade between EEC members is free of customs duties. The rates and categories of customs duties are set out fully in the Customs and Excise Tariff of Ireland. Individual member countries are not empowered to alter rates unilaterally. While customs duties collected in Ireland are payable to the Exchequer in the first instance, they are eventually remitted in full³ to the European Communities as part of the 'own resources' of the Community. The 'own resources' are used to finance the various EEC programmes.

Agricultural Levies (EEC)

2.12 In the milk sector a co-responsibility levy on milk production amounting to 2 per cent of the target price (currently⁴ 97.53 pence per gallon) is payable by milk producers. Those in disadvantaged areas (i.e. the twelve Western counties) pay 1.5 per cent of the target price on their first 12,800 gallons. This money is collected by the dairies/creameries and is transmitted through the Department of Agriculture to the EEC. Some of the money collected from the milk levy is used to finance projects aimed at expanding the markets for milk and milk products and to improve the quality of community produced milk. The remainder (if any) is used for priority areas in the milk sector, such as the financing of export refunds⁵ and low cost disposal of skimmed milk powder as animal feed. The total proceeds of the levy collected in Ireland in 1982 amounted to £17.7 million.

2.13 Levies are payable on the production of sugar. Production levies are payable at rates fixed by the EEC. This levy is meant to offset EEC expenditure on export refunds⁵ for sugar.

³ A reimbursement of 10 per cent of the amount paid is refunded to each member state to cover the costs of collection.

⁴ As at January, 1984.

⁵ Export refunds on CAP products are paid to exporters in order to eliminate as far as possible the difference between Community price and the price prevailing on the world market for the product in question.

2.14 Monetary compensation amounts (MCAs) are designed to protect producers of agricultural products covered by the EEC Common Agricultural Policy from currency fluctuations. In the event of a currency devaluation, the advantage to exporters is neutralised by the imposition of a charge on exports and the disadvantage to importers is neutralised by a subsidy. In the case of currency appreciation, exporters are compensated by a subsidy and importers incur a charge. In Ireland MCAs have taken the form of a levy on exports and a subsidy on imports of the goods affected. The Revenue Commissioners are responsible for the collection of the export levy which is remitted to the European Communities. An outline of the historical development of MCAs in Ireland and a note on their effects on trade are in Appendix 4.

2.15 Customs duties levied under the Common Customs Tariff of the EEC and agricultural levies imposed by the EEC Common Agricultural Policy will not form part of our review of the Irish taxation system. In essence these duties and levies are Community taxes over which Ireland has no independent control.

Stamp Duties

2.16 Generally speaking, stamp duties are levied on written legal and commercial instruments, that is, documents in the broadest sense. They find their main sanction in the fact that instruments are generally not admissible for the purpose of legal proceedings unless they are duly stamped, which, in turn, requires the prior payment of the duty. The amount of the duty chargeable is determined by the nature of the transaction effected by the written instrument.

Miscellaneous Fees

2.17 The National Income Accounts include as taxes on expenditure broadcasting licence fees, excluding amounts transferred to RTE and certain 'other fees'. The amount of broadcasting licence fees included as tax revenue represents the administrative costs incurred by An Post in the collection of the fees. The sums transferred to RTE are not regarded as tax revenue.

2.18 The other fees mentioned above include charges which fall principally on individuals; such as fees payable by applicants for driving licences, fees for searches, certified copies of entries of births, deaths and marriages, and charges which fall on businesses, such as film censorship fees, inspection fees under Fish Meat Acts and Pig and Bacon Acts, or receipts under the Trade Mark Act, 1963 and Patents Act, 1964. The total of such receipts is included in the National Income Accounts as part of the taxes on expenditure. The United Nations System of National Accounts treats such fees as compulsory fees where paid by individuals and as indirect taxation where

paid by businesses. Thus, for example, the fees paid under the Trade Mark Act, 1963 and the Patents Act, 1964 would be regarded as indirect taxes. However, the revenues collected from these sources are relatively small and in many cases cover only the costs of collection and administration.

CHAPTER 3

CRITERIA FOR A GOOD INDIRECT TAX STRUCTURE

Introduction

3.1 In this chapter we set down in general terms the requirements of a good indirect tax structure. Such a structure must conform as far as possible to the criteria of equity, efficiency and simplicity which we set out in our first report. The indirect tax structure may or may not be equitable if looked at in isolation. This does not matter very much. What is important is that it forms part of a general system of tax and public expenditure which is equitable. We also identify some of the main international and other constraints which we must take into account in making our recommendations.

Equity

3.2 In our first report we concluded¹ that taxation should be levied in accordance with ability to pay. Taxpayers in the same circumstances should pay the same amount of tax. Those with greater capacity to pay should pay more. However, the tax system is only one part of the re-distributive process. The other is public expenditure. In the pursuit of equity, the tax system cannot be judged in isolation but must be looked at in conjunction with government expenditure which is financed ultimately from tax revenue.

Efficiency

3.3 Economic efficiency requires that indirect taxes should be levied in such a way as to minimise the distortion of consumer and producer choices except in cases of market failure. It could be argued that this requires that indirect taxes be concentrated on those products which are least price sensitive, because these taxes would then have the least effect upon the pattern of consumer expenditure. However, this is not the case. To see

¹ Paragraph 3.4.

what actually happens we must distinguish between the income and substitution effects of taxation.

3.4 Heavier taxes on goods and services will reduce the value of a taxpayer's real disposable income unless this is compensated for by increases in government expenditure or reductions in direct taxation. The taxpayer will adjust to this decline — the income effect — by reducing the volume of his consumption of different products by different amounts depending on their relative attraction for him. If the price of all commodities increases at the same rate, the taxpayer will have no incentive to substitute one commodity for another. However, if one commodity is subject to a special tax, he will have an incentive to switch from the use of that commodity to others — the substitution effect. Income effects are not a symptom of economic inefficiency and waste; they are merely the result of the most effective way of meeting the inevitable cost of given tax burdens. But substitution effects are an indication of waste, even if they do no more than offset the influence of income effects.

3.5 Indirect taxes may also increase economic efficiency if they compensate for the failure of the market to reflect accurately all the costs and benefits involved in producing or consuming specific goods and services. For example, a householder does not bear the costs of disposing of the smoke and sulphur waste products of his open fire. A special tax on fuel related to the costs imposed by these waste products would improve economic efficiency.

3.6 It is also desirable that indirect taxes should be neutral in their effects upon production and distribution techniques, that is, they should not alter the relative advantages of various methods of distribution and production. For example, if the burden of tax is greater when goods are sold directly by the producer to the retailer, than when sold through a wholesaler, firms will be discouraged from making direct sales; if, however, the tax burden is less, firms will be encouraged to eliminate as many independent transactions as possible in order to avoid tax. To prevent effects of this nature the amount of tax on a commodity should be the same, irrespective of the type of distribution network used.

3.7 If the various methods of production are to remain unaffected by the tax then it must apply only to final consumption goods. If any producers' goods, that is, goods used for further production, are included in the tax base, the costs of some methods of production will be higher than others, and the selection of production methods will be altered.

3.8 The indirect tax structure must also be compatible with the aims of industrial policy. Ireland's economic future is dependent on developing a series of high value-added quality goods and services for export. To assist

in this process, a viable home market for many of these products is necessary so that manufacturers can develop them. It is important that the system of taxation adopted in Ireland should not inhibit this process by effectively killing the market for such products by excessive levels of taxation.

3.9 Indirect taxes are also useful as economic regulators. Changes in such taxes may be the most appropriate method of short-term demand management.

Simplicity

3.10 It is desirable that indirect taxes should not impose heavy compliance costs on the taxpayer, or undue administrative costs on the Revenue Commissioners. Where the tax is self-assessed it is important that the procedures and forms should be simple and straightforward and that small businesses in particular be provided with the assistance needed to operate the tax. If they are to be effectively policed, most taxes will require the maintenance of some accounting records on the part of the taxpayer. To the extent that such records extend beyond those which should normally be maintained for business purposes, they are equivalent to an increase in tax that is not reflected in government revenue. We are aware of the need to avoid burdening the taxpayer with indirect taxes that are unduly complicated in their operation. The smaller the number of taxpayers for any given amount of revenue with whom the administration has to deal, the simpler is the system.

International Constraints

3.11 As a member of the EEC, Ireland is bound by the various directives on the harmonisation of indirect taxes within the Community. These directives, inter alia, prohibit member countries from using any form of sales tax collection other than value-added tax. They also define the taxable person, taxable event and a common basis of assessment for value-added tax purposes. We are very much aware that our proposals for reform of indirect taxation should not conflict with EEC directives. In particular, we recognise that we are effectively precluded — not that we would wish to — from recommending a change from the existing value-added tax system for the collection of sales tax.

3.12 Constraints also arise from the need to take account of taxes levied in other countries. Irish taxes must have some regard to the relative competitive position of businesses which have to compete on international markets.

3.13 A further constraint on the level of taxation on certain goods and services arises from the need to avoid the prices of these items becoming

significantly higher than the prices obtaining in Northern Ireland and Britain, after making due allowance for differences in currency values. If prices in the Republic become significantly higher, trade is likely to be diverted to Northern Ireland, leading to loss of tax revenue, adverse balance of payments effects and serious damage to the livelihood of traders in border areas.

Conclusion

3.14 It is obvious that no type of indirect taxation can fulfil the requirements of equity, efficiency and simplicity perfectly. However, provided indirect taxes are simple and efficient, it suffices if they form part of a general system of tax and public expenditure which is equitable. In recommending an indirect tax structure, account must also be taken of the constraints imposed by Ireland's membership of the EEC and by the need to have regard to the levels of taxation applied in other countries.

Part II

Value-Added Tax

CHAPTER 4

VALUE-ADDED TAX

Introduction

4.1 In this chapter we outline the characteristics of value-added tax and describe in general the way in which the tax works. We examine the reasons for its adoption by the EEC, discuss what we feel are its advantages and compare it with alternative taxes. We conclude that value-added tax is superior to these taxes. Appendix 5 describes the evolution of the tax in Ireland and summarises its main provisions.

Definition

4.2 In simple terms, 'value-added' is the difference between the amount which an enterprise receives from the sale of goods and services and the amount which it lays out on the purchase of goods and services from others. This difference normally represents its outlay on wages, salaries, interest and, in addition, its profits. It is because the tax at each stage of production and distribution is related to the value added at that stage that value-added tax is so called. Thus, the purpose of the tax is to charge at each stage, not the full turnover, as under the cascade system, but only those elements in the turnover which represent value-added. In the actual operation of the tax the full turnover is in fact charged at each stage, but a credit or deduction is allowed for tax already borne on all purchases of goods and services. Goods in this context cover not only raw materials and fuel but also capital goods, whether plant and machinery or buildings.

Methods of Value-added Taxation

4.3 There are three ways of computing value-added in an economy. The first of these calculates value-added by reference to the sum of all final goods and services produced and sold during a given period, i.e., the entire gross national product. A value-added tax in this context would be applicable to both consumer and capital goods and would be levied at each stage in the production and distribution process on the excess of gross receipts over the cost of purchasing intermediate goods from prior producers. The

tax base at each stage would equal the sum of depreciation, wages, interest, profit and rent.

4.4 The second means of quantifying value-added is by deducting capital consumption from gross national product, giving a figure corresponding to net national product. A value-added tax here would be imposed by taxing the *net* value added by each firm, with 'net value-added' defined as gross receipts minus purchases of intermediate goods *and* depreciation.

4.5 The third measure of value-added is to subtract capital formation from gross national product, which gives a result identical to aggregate consumption. This involves deducting purchases of bought-in goods and services from turnover and making a further deduction for the cost of *all* new capital goods (whether for replacement or expansion) rather than just for capital consumption. If value added is computed in this way for each firm in the economy, the total will then be equal to that of aggregate consumption expenditure. The base of the value-added tax is thus defined as a firm's gross receipts minus the value of all its purchases of intermediate products (materials and goods in process) as well as its capital expenditures on plant and equipment. Permitting each firm to deduct its capital expenditures leaves the value of consumer goods output only. The value-added tax in this instance is equivalent to a general retail sales tax on consumer goods, the two differing in administrative procedure only.

4.6 There is a crucial difference between the first two variants of VAT and the third. The first two differ from one another but are both a form of income taxation while the third is a tax on consumption rather than on income. The third variant operates in EEC countries and elsewhere. While there have been cases where deductions for capital expenditure were incomplete, these are now only of historical interest. Therefore, we concentrate on the third variant in the discussion which follows.

Operation of VAT

4.7 With the consumption type of value-added tax, we have seen that each firm computes its tax base as sales minus purchases of intermediate and capital goods. When it has done so, there are two methods of calculating the tax liability. The first is the 'base-from-base' or accounts method, the second is the 'tax-from-tax' or invoice method.

4.8 Under the base-from-base method, the firm calculates the value-added by subtracting from sales the sum of the costs of all goods purchased and applies the tax rate to this figure. This means that value-added tax would not be shown separately on sales invoices. In setting their prices, businessmen have to estimate in advance the amount of tax that accurately reflects their value-added and for many firms this introduces an element of

uncertainty. The method is simple and accurate only as long as the tax rates on the inputs of the firm are uniform and there are no exemptions from the tax.

4.9 Under the tax-from-tax method, the computation system used in the EEC, each business separately states the VAT it charges on its sales invoices to registered persons. Businesses determine during each taxable period the VAT collected or invoiced on sales, subtract VAT paid or invoiced on purchases of inputs and pay over the remainder to the tax collecting authority. The remainder represents the tax on the value each business has added to its output. A business which has borne more VAT than it has collected or invoiced during the period receives a refund or credit from the tax collecting authority. Each business attempts to pass its VAT costs onto its customers until the product is sold to the retail customer, who ultimately is intended to bear the tax burden. In most countries, including Ireland, the tax element in the final retail price is not shown separately; only the tax-inclusive price of the product appears on the retail invoice. The consumer therefore is not in a position to determine the amount of sales tax that he is paying on his purchases unless he knows the rates of VAT applicable to his purchases and is willing to do some arithmetic.

4.10 Other things being equal, either method will produce the same revenue. The tax-from-tax method, unlike the base-from-base method, requires a separate statement of tax on each invoice. This practice avoids the uncertainties associated with predicting the tax factor in advance which arise under the base-from-base method. Furthermore, the tax-from-tax system can fully 'recapture' tax where exemptions and different rates are a feature of the tax base. Finally, under this system, exporters are not faced with complications in determining the amount of tax rebate required to obtain full relief. It is mainly for these reasons that the EEC opted for the use of the tax-from-tax method.

4.11 While value-added tax systems can be very simple, in practice almost all include multiple tax rates and/or exemptions. In addition to the standard rate, VAT systems may include

- (i) higher rates on 'luxury items',
- (ii) a reduced rate, and
- (iii) a zero rate, applicable to exports and, in some countries, a range of other goods and services.

VAT in the EEC

4.12 The EEC adopted VAT to reduce trade distortions between its members. This was seen as a further step towards ensuring the free movement of goods and services within the Community.

4.13 On 1 April, 1967, the EEC Council of Ministers directed its member states to replace their existing national consumption tax systems with VAT by 1 January, 1970. (The operative date was later revised to 1 January, 1972). This was to be the first major step in EEC tax harmonisation. By 1973 all the then members of the EEC, including Ireland, had adopted VAT. The newest member country of the EEC, Greece, has not yet introduced VAT.

4.14 Prior to April, 1967, each of the original EEC members, with the exception of France,¹ operated cascade turnover tax systems. The perceived drawbacks of cascade turnover taxes in a common market environment were the most important impetus to the selection of VAT. The cascade turnover tax is similar to VAT, except that every time materials or products change hands the tax is paid on the full value of the product, including taxes previously paid, hence the cascade or multiple taxation effect. As a consequence, the effective tax rates on similar products could differ, depending on the extent to which an industry or firm was vertically integrated.² This led to inequities and resulted in a tax content which could not be accurately measured in the final product price.

4.15 The inability to determine accurately the tax element of a finished product had implications for *intra*-EEC trade in that it caused a potential distortion in trade competition. Under the General Agreement on Tariffs and Trade (GATT), governments are permitted to rebate the indirect tax content of their exports and impose all applicable indirect taxes on imports. Since governments were unable to determine the exact cascade tax element of domestically produced goods, they were forced to estimate the border tax adjustment based on so called 'average rates' of tax. The calculation and operation of such average rates gave rise to many cross-border problems in the member states and also to complaints of subsidisation of exports. This arose because a clear tax advantage could be gained for domestic products

¹ France operated a value-added tax system but in addition there was a retail turnover tax which accrued to the benefit of the local authorities. A wholesaler could opt to be charged under the retail turnover tax instead of under the value-added tax.

² Under a cascade tax, firms have a powerful incentive to eliminate as many independent transactions as possible. While vertical integration may in some instances lead to increased efficiency, this is not necessarily so and the encouragement of integration by a cascade tax is undesirable. The tax discourages the separate ownership of the various stages of production and distribution.

from overestimating the rate of tax to be refunded on exports and levied on imports. In order to overcome this barrier to the free movement of goods and services, value-added tax was chosen over a number of alternative tax systems because the tax always represents an ascertainable proportion of a product's price.

4.16 Although there are EEC directives on VAT, member countries still have a high degree of discretion regarding the choice of rate structure and administrative system. Consequently, the VAT systems within the Community differ in many respects. For instance, the VAT rates charged range from a single rate to seven rates, and the filing periods of returns range from one month to three months. In Ireland returns are filed at two monthly intervals and there are six rates of VAT.

The Sixth Council Directive on VAT³

4.17 One of the most important EEC directives on VAT is the Sixth Directive on Value-Added Tax which prescribes a uniform basis of assessment. This directive was designed to ensure that the Community's own resources from VAT were collected equitably. In particular, the directive deals with the rules governing liability, the definition of taxable transactions, taxable amounts and chargeable event. In principle, the directive places limitations on future freedom of action, especially in the number of zero-rated items and the exemptions from the tax. However, to facilitate the move towards a common system of value-added tax, it allows temporary (at least five years) departures from most aspects of the common provisions proposed. These transitional provisions are summarised in Appendix 6. A brief description of the calculation of the value-added tax element of the Irish contribution to the EEC budget is in Appendix 7.

The Advantages of VAT

4.18 The main advantage of value-added tax is its neutrality in relation to both international and domestic trade, because it eliminates the price distortions which result under a multi-stage turnover tax and which may occur to some degree under a single-stage turnover tax. Under a value-added tax the precise element of tax in the cost of goods can be determined at any stage, and each person in the chain of production and distribution can take credit against the tax liability on his output for the tax borne by him on his input items, including capital expenditure for business purposes. The result is that the proportion of tax in the final price of any particular product is the same, irrespective of the number of stages through which it

³ 77/388/EEC (17 May, 1977) [OJ No. L145.1, 13.6.77].

may pass. Accordingly, the tax content in the price of goods can be precisely determined and allowed for.

4.19 Neutrality in the domestic field ensures that small enterprises can compete on equal terms with large integrated enterprises with regard to the payment of tax. Neutrality in the field of international trade means that a rebate is given representing the precise amount of tax in the price of the goods exported, and the amount of tax charged on imports is the same as on similar home-produced goods of equal price. This latter is very important in relation to exports, because any unrelieved tax places an exporter at a disadvantage compared with competitors from countries with a more favourable sales tax system.

4.20 Value-added tax does not involve any significant element of double taxation because full credit is given not only for the tax paid on raw materials but also for the tax paid on capital equipment, thus, there is no barrier to modernisation of industry.⁴

4.21 Value-added tax makes evasion of tax less profitable than under a single-stage system since the amount which any one taxpayer has to pay is smaller, and the incentive to evade is correspondingly less. Moreover, evasion is more difficult because the system, apart from the retail stage, affords a method for cross-checking the records of taxable persons. This is so because of the important role of the invoice in the operation of the value-added tax. The amounts shown on invoices represent ingredients in the calculation of the tax liability of both the seller and the buyer and are recorded as readily identifiable items by both. The Revenue Commissioners, by cross-checking suppliers with purchasers, can try to prevent evasion or catch evaders. The resources required for detailed checking between firms rule it out as an automatic controlling device, although it would be feasible to check back with the suppliers and customers of a particular firm under suspicion.

4.22 VAT is to some extent self-policing. Anyone seeking to evade VAT will wish to overstate his input tax and understate his output tax. But, since one man's input tax is the other man's output tax, each trader's interest for purposes of evasion is contrary to that of his suppliers and of his customers. Collusion between two registered persons may lead to the suppression of both the sale and the purchase, followed by the suppression of the subse-

⁴ Unregistered farmers may reclaim the tax borne or paid on expenditure on the construction, extension, alteration or reconstruction of farm buildings or on land reclamation, provided the expenditure qualifies for a grant from the Department of Agriculture, Roinn na Gaeltachta or the Land Commission. In addition, farmers who do not register for value-added tax are compensated for the tax they are charged on their purchases, such as agricultural machinery or parts, by means of a 2 per cent flat-rate addition to the prices at which they sell their produce to persons registered for VAT.

quent resale by the purchaser, or the fraudulent creation of an invoice for a non-existent purchase, or similar action in relation to a real purchase, acquired from a non-taxable source, for example, smuggled goods. But, collusion to evade on this basis is unlikely to be widespread.

4.23 However, neither the cross-checking nor the self-policing mechanism works at the retail stage; and it is consequently at that stage that most evasion is likely. Because of the absence of sales invoices, a taxpayer may be able to minimise his tax liability by suppressing his sales volume. The incentive to evade tax on sales is greatest when rates of tax are high. A knowledge of retail margins helps control evasion but does not eliminate it. This is especially true where widespread cash and carry facilities are available and in the service trades where a high proportion of value-added is produced at the final stage and there is little or no tax on inputs which can be checked. But VAT has the advantage that only part of the tax is collected at the retail stage. Consequently, with VAT, the incentive to evade and the revenue at risk at the retail stage are much less than with a retail sales tax having the same rates and revenue yield.

VAT and Inflation

4.24 VAT is automatically adjusted for inflation. The base is simply the value of current transactions and tax receipts rise automatically as prices rise. This is an undoubted advantage of the tax and is in sharp contrast with the substantial effects inflation has on other taxes. However, proportional taxation can distort competition by magnifying differences in pre-tax retail prices of competing goods and services into large tax inclusive differences in actual retail prices. For example, if one item sells for £100 more than a competing lower quality item, the imposition of VAT at 35 per cent will widen the price differential to £135. These distortions are minimised if rates of tax are kept low.

VAT Compared to Other Forms of Sales Tax

4.25 At this stage in our analysis of value-added tax, a comparison with its 'competitor' taxes is necessary. A brief examination of other forms of sales tax is in Appendix 8. We are conscious, of course, that EEC regulations would prevent the adoption of any such taxes by this country even if they were thought to be desirable.

4.26 Value-added tax offers the prospect of avoiding the objectionable features of turnover tax, without at the same time concentrating the impact of the tax heavily on one group of taxpayers, as is the case with single-stage taxes. A value-added tax may encompass all stages of production and distribution, or it may be confined to just one stage. In taxing consumption

both the value-added and single-stage forms of tax collection achieve a similar result. Value-added tax yields the same amount as is yielded at one level only under a single-stage tax but does this in the form of incremental payments at each transaction stage. Value-added tax and single-stage taxes also achieve the same distribution of burden by commodity, assuming that the value-added tax is fully shifted forward.

4.27 Compared to the single-stage retail tax, value-added tax offers many advantages. Firstly, the direct impact of the tax is diffused over a larger number of firms instead of being concentrated exclusively on retailers. For example, under the former Irish turnover tax, a large brewery or distillery supplying 4,000 or 5,000 publicans would remit little or no tax because most of its output would be sold to registered traders. The tax on the consumption of drink was collected from thousands of comparatively small traders while the strongest economic unit in the chain of distribution remitted no tax. Under the value-added tax system, however, the greater part of the tax on drink consumption is collected in a few payments from brewers and distillers who, in effect, operate a 'deduction at source' system for their customers. The collection of a high percentage of the total tax from manufacturers and wholesalers reduces the danger of evasion, especially if the rate is high.

4.28 Secondly, assuming the tax-from-tax method is used, cross-checking of the returns of various firms is facilitated. Exclusion of producers' goods can be controlled much more effectively under a value-added tax than with a single-stage retail tax. In the case of the value-added tax, capital goods are taxed when sold but the buyer is allowed deduct the tax on them from his overall VAT liability. Exemption of capital goods from a single-stage tax is achieved by allowing the trader's suppliers to make supplies to him tax-free. The great advantage of the value-added tax system is that the responsibility for the tax rests with the trader concerned whereas, under the other system, the trader making the tax-free supply is held responsible by reference to factors or circumstances relating primarily to his customer over which he can have no control.

4.29 Value-added tax is a more complex tax than single-stage taxes. Firms have to keep records of tax on purchases and on sales. Tax returns are more complicated and auditing is more intricate. However, most of the additional administrative complications and compliance costs result from exemptions and differential rating. A value-added tax applied at a uniform rate to all transactions is a relatively simple tax to operate.

4.30 Compared to the cascade turnover tax the advantages of value-added tax are many. The discrimination against non-integrated firms is completely eliminated. So also is the incentive towards vertical integration. The only

disadvantage of the value-added tax, compared to the cascade turnover tax, is that a higher tax rate is necessary to produce any given level of revenue.

4.31 Leaving aside Ireland's EEC obligations, we believe that, on balance, the value-added tax through to the retail level is superior to other forms of sales taxes. Even if Ireland were no longer obliged to use value-added tax, we would be happy to recommend that the existing value-added tax system for the collection of sales tax be retained.

The Future of VAT

4.32 Any discussion of the future of VAT must have regard to the EEC context. It is clear that much of the future development of VAT will inevitably flow from EEC attempts to move closer to the realisation of the long-standing objective to abolish fiscal frontiers between member countries. After the common basis of assessment specified in the Sixth Directive is fully operational, further movement towards this end would involve the imposition of a common rate structure. When both the common base and rate structure have been implemented throughout the Community the way will then be open for the abolition of fiscal frontiers. This implies a move from the present destination basis to an origin basis for intra-Community trade. It seems likely at this stage that such a move will require a uniform rate of VAT within the Community. However, progress in this direction is likely to be extremely slow.

The Sixth Directive and its Impact on the Irish Value-added Tax

4.33 The Sixth Directive which, as we have noted, is concerned with achieving a common VAT system for EEC member states, limits strictly a member state's freedom to depart from the uniform basis of assessment adopted by the directive. The general effect of the directive on the Irish VAT regime is that no further exemptions or zero-ratings may be introduced and that, after a transitional period of not less than five years, most of the existing zero-ratings and some of the existing exemptions must be discontinued. At the end of a transitional period, which may be considerably longer than five years, the following are to become taxable:

food and oral medicine	(at present zero-rated)
children's clothing	(at present zero-rated)
footwear	(at present zero-rated)
books ⁵	(at present zero-rated)

⁵ Article 28(2) of the Sixth Directive broadly allows member states to maintain reduced rates which were in existence on 31 December, 1975, at least until fiscal frontiers between member states are abolished. The zero-rating of books was introduced on 1 May, 1982. Infringement proceedings have been initiated by the Commission.

passenger transport	(exempt)
telecommunications services	(exempt)
admissions to sporting events	(exempt)
horses and greyhounds	(exempt)
funeral undertaking	(exempt)
certain professional services	(exempt)

Some other exemptions of a minor nature will also be affected.

4.34 A further effect of the Sixth Directive is that those activities which are exempted under the directive cannot be brought within the charge of VAT. These activities include banking, insurance and betting, in addition to education and medical care.

4.35 Despite the seemingly pre-eminent role of the EEC in VAT matters, many changes in the structure and operation of VAT could be made at a national level. We also consider whether changes which might be imposed eventually on Ireland by EEC obligations are desirable in their own right and should be implemented more quickly. We examine these possibilities in Chapter 5.

Conclusion

4.36 We conclude that value-added tax is the most desirable form of broadly-based sales tax.

CHAPTER 5

STRUCTURAL ASPECTS OF VALUE-ADDED TAX

Introduction

5.1 In this chapter we consider the goods and services which should form the base for value-added tax and we examine the rate structure that should be applied to these goods and services. We conclude that the base for value-added tax should be widened significantly and that the long-term objective should be to charge value-added tax at a single rate on as wide a base as possible. In Chapter 14 we discuss the transitional measures that are necessary.

The Objective

5.2 The history of value-added tax in Ireland has echoes of a familiar theme. In 1972, the tax began its life as one levied at reasonably modest and acceptable rates on a wide base. Since then the base has been steadily eroded and the rates of tax on the remaining items have been increased to unacceptable levels. This increases the pressure for further concessions which are very difficult to resist on any rational basis.

5.3 We believe that it is time to revert to first principles — to widen the base and to reduce the rates on goods and services which now bear value-added tax at rates which, with no sense of irony, are referred to as low (23 per cent) and standard (35 per cent). Much of the diversion of trade in border areas at present arises because the rate of value-added tax in the United Kingdom is 15 per cent. The Revenue Commissioners informed us that the present structure of value-added tax is broadly equivalent to a single rate of 14.4 per cent, arithmetically calculated. They also told us that some allowance should be made for the increased efficiency and better compliance which could be expected under a single rate.

Value-added Tax Rate Structure

5.4 Exemptions and differential rating make the administration of value-added tax more difficult and increase compliance costs because of the additional record-keeping necessary to segregate sales into their appropriate tax classifications viz. exempt, zero-rated, 5 per cent, 8 per cent, 18 per cent, 23 per cent or 35 per cent. They also facilitate evasion and make enforcement more difficult. Exempt and low rated goods and services result in discrimination against those persons who have relatively low preferences for such goods and services. Closely related to this is the distortion in the demand for and supply of goods and services caused by exemptions and differential rating. Generally speaking, changes in relative prices resulting from taxation alter the allocation of resources among various possible uses. Unless these changes compensate for market imperfections, the allocation of resources is distorted and Irish people are poorer as a result. In order to raise a given revenue the existence of exemptions imposes a higher effective tax rate on goods and services subject to tax than would be required under a comprehensive sales tax. High rates are an incentive to evasion, particularly at the retail level, where the system of cross-checking of invoices cannot apply. Moreover, the use of a number of different taxable categories inevitably results in some misapplication of tax and it facilitates evasion through misreporting of sales.

5.5 In our view, a sales tax is fundamentally a simple tax to operate but only if it is applied uniformly to all transactions. Experience of other countries shows that most of the compliance costs and administrative complications result from exemptions and differential rating.

5.6 We received submissions which criticised the compliance costs imposed on taxpayers in meeting their obligations under value-added tax. There is no information on the extent of compliance costs in Ireland. A United Kingdom study¹ estimated that the private compliance costs associated with value-added tax in 1977-78 represented more than 9 per cent of revenue while public administrative costs were 2 per cent. The study concluded that a significant proportion of these costs resulted from administering the zero-rate of tax.

5.7 The study found that many businesses could show substantial offsets to their compliance costs in the form of managerial and cash flow benefits. Managerial benefits arose from the improved record-keeping that VAT has required of some firms, especially smaller ones, which may result in better

¹ Costs and Benefits of VAT, C.T. Sandford, M. Godwin, P. Hardwick and I. Butterworth. Heineman Educational Books, 1981.

decision-making and improved efficiency. However, the survey found that traders thought this was of limited value. More significant in the aggregate were the net cash flow benefits to business. However, only improved record-keeping of firms which generates improved business efficiency represents a real gain to the community. Any cash flow benefits are in the nature of a transfer which may affect the resource costs to the trader but not to the community as a whole.

5.8 Since 1977-78, various measures have been introduced in the United Kingdom to simplify value-added tax. A major simplification was the elimination in 1979 of a separate higher rate above the standard rate. Data from the research suggested that the existence of a higher rate above the standard rate added about 9 per cent to compliance costs in 1977-78. It also increased administrative costs.

5.9 We discussed the operation of the present VAT structure with the Revenue Commissioners². They drew our attention to the following unsatisfactory features of the present system:

- “(i) The existing rate structure gives rise to substantial repayments of tax. The gross receipts amount to about £1,900 million of which £800 million must be repaid. These repayments have to be made within three weeks, and control by the Revenue Commissioners is, of necessity, less than they would wish.
- (ii) While VAT returns are checked against income tax returns, these checks are of little real value for VAT purposes because of the number of different rates of VAT.
- (iii) The present system bears most heavily on those least able to comply with it — for example, small retailers who sell goods liable at all rates. The VAT return form has thirty-eight entries which leads to confusion. Liability to VAT in these cases is determined by apportioning sales in the ratio of purchases in that taxable period. Since sales are never related precisely to purchases in the same period, this leads to absurd results in some instances. Seasonality of purchases and sales is a major contributory factor to these distortions.”

5.10 The present system also leads to considerable anomalies. Soap, toothpaste, toilet tissues, prams and bicycles are taxed at 35 per cent while luxury items of clothing are charged at 8 per cent. Other anomalies were also drawn to our attention. For example, Chivers and Sons Limited advised us that they

² Meeting of 13 July, 1983.

"sell glacé cherries in addition to candied peel primarily for the purpose of baking. Candied peel is zero rated for the purpose of VAT while glacé cherries attract a 23 per cent VAT".³

5.11 Anomalies such as these are ridiculous and unjustifiable. They bring taxation into disrepute. However, it is well-nigh impossible to avoid them under a multi-rate system.

5.12 On this basis we conclude that there are clear administrative advantages to be obtained from having a single rate applied to all goods and services supplied in the state. The zero rate would continue to apply to exports including goods supplied to a registered person within the Shannon customs free airport. These administrative arguments may be insufficient if there are strong economic and social arguments for retaining a relatively complicated rate structure. We now consider these arguments.

EQUITY

5.13 We concluded in our first report⁴ that an individual tax which is regressive is not necessarily an undesirable form of raising revenue. Equity is an aggregate issue. If a tax is efficient and relatively simple to operate, then the regressivity of the tax can readily be offset elsewhere in the tax system, or through adjustments in public expenditure. In the pursuit of equity, the tax system cannot be judged in isolation but must be looked at in conjunction with government expenditure which is financed ultimately from tax revenue.

5.14 The main argument against having a single rate of value-added tax charged on all consumer goods and services is that this is unfair. This argument usually assumes that tax is passed on to consumers in the form of higher prices. On this basis the proportion of a person's income which will be taken by a flat-rate general sales tax will depend on the proportion of his income spent on personal consumption. This proportion tends to decline as income rises. Therefore, it is argued, a sales tax is regressive in its incidence in relation to income. In particular, 'necessary' expenditures on items such as food comprise a larger proportion of lower income budgets than of higher income budgets and the impact of sales tax on these items has been the traditional basis of opposition to such a tax.

5.15 The conclusion that a general value-added tax on all items of consumption is regressive is based on evidence from cross-section data which

³ Letter of 12 September, 1983.

⁴ Paragraph 21.27.

show that in a particular period,⁵ families with low incomes in that period consume a higher fraction of their incomes than high income families. The proportion of income consumed is shown to decline as one moves up the income scale. If a general value-added tax is measured against income as shown in household budget surveys, the tax will appear regressive.

5.16 The validity of evidence drawn from a cross-section for any relatively short period may be questioned. Evidence that consumption falls as a proportion of income as income increases for any period is consistent with a wide range of hypotheses regarding the relationship of consumption to income at different levels over a longer period. Households in any given income range will include those whose income is permanently in that range, as well as others who occupy it only temporarily. In the low ranges, this temporary group will consist generally of households whose income is normally higher. If such households tend to maintain past consumption patterns or anticipate future income increases, they will consume more than households with permanently low incomes. As a result, use of cross-section data overstates the decline in the average proportion of income consumed as one moves up the income scale and, with it, the regressivity of a general value-added tax as applied to the more permanent income position of households, which is the ideal base against which to measure the overall progressivity of the tax/expenditure system.

5.17 If all income were consumed over a person's lifetime, a general tax on consumption would be proportional to lifetime income. However, not all income is consumed and capital is accumulated. It seems reasonable to assume that the ratio of capital accumulated to lifetime income rises when moving up the scale of lifetime income. Therefore, a general tax on consumption remains regressive in relation to lifetime income, though not to the degree implied by results from cross-section data. This assumes that the tax is fully shifted to consumers.

Incidence of Value-added Tax

5.18 The conclusion that indirect taxes are regressive is also based on dubious assumptions about the incidence of these taxes. The formal incidence falls on those who have the actual legal liability for paying the tax. In the case of value-added tax, this is the manufacturer, wholesaler, retailer or importer. However, formal incidence is not really important. What matters is the effective incidence which identifies those who are, in the end, the

⁵ The Household Budget Survey 1980 CSO pl. 1221 December, 1982 pxi states "Although the expenditure data for a particular household were based on records kept during the survey period ... while expenditure was, by and large, surveyed on a current basis a considerable proportion of income, particularly own-account income and investments, had to be based on retrospective data relating to some twelve month period preceding the interview".

people who are poorer as a result of the imposition of the tax. It is generally assumed that value-added tax is essentially a tax on consumers. This is an over-simplification, particularly when special discriminatory rates of tax are levied on certain commodities. For example, if a special rate of tax is levied on a range of goods, say hotel services, their price will rise and the purchasers of such services will pay more tax. However, the demand for hotel services is likely to fall, as will profit margins of hoteliers. The earnings of hotel employees may fall and some of them may lose their jobs. Thus, while part of the incidence of such a tax may fall on consumers, some of it will fall on employers and employees in the hotel industry.

5.19 As a general rule, the greater the fall in demand for a product resulting from a rise in its price, the less likely is a tax on that product to be shifted to the consumer. Thus, taxes on luxury goods and services, which by definition are inessential, are much more likely to be borne by the persons engaged in the production of these products. For this reason, it is extremely dangerous to put any reliance on the simple view of tax incidence that value-added tax is borne by the consumer.

5.20 The incidence of the tax in a multi-rate system results from the way in which retailers selling goods at two or more rates decide to recover the tax by way of increasing prices. We have discussed this question with various interests. The consensus about what actually happens in practice may be illustrated by a simple example. Take the case of a retailer who is not subject to price control and who sells products liable to value-added tax at a number of different rates — say zero, 23 per cent and 35 per cent. He learns from experience that if he charges the tax at 35 per cent on the goods which bear that rate, demand for them collapses. To compensate for this he reduces his profit margins on such goods and increases them on goods which bear lower rates. This means that part of the tax on luxuries is actually shifted by the retailer to essentials. Market forces give him no other choice. Therefore, even if certain goods are exempt from tax, they may still bear some of the burden of taxation.

5.21 The Revenue Commissioners confirmed that in their experience the fact that because

“a particular product was charged at a low rate of VAT did not necessarily benefit the final consumer. In reality traders were faced with recouping a certain amount of VAT from consumers. They adjusted their prices in line with what the market would bear regardless of the rate of tax prescribed for individual items.”⁶

⁶ Meeting of 13 July, 1983.

Zero-rating and Equity

5.22 The main reason given for charging zero or low rates of value-added tax on certain goods and services is to try to improve the equity of the tax system. Zero-rating of food was introduced in Ireland in 1973. Certain clothing, footwear, clothing material and fuel were zero-rated in 1975. The rate on fuels, except electricity, was raised to 5 per cent in May, 1983. The rate on clothing, other than children's clothing, and clothing material was raised to 8 per cent in May, 1984. Since the poor spend a higher proportion of their incomes (expenditure) on basic commodities such as food than do the rich, it is argued that low rates of tax on such items must have desirable income distribution effects.

5.23 While this notion seems plausible, it does not stand up to analysis. Reduced rates of tax benefit all consumers, irrespective of their circumstances. As a result most of the revenue foregone does not end up in the pockets of the poor. Zero or low tax rates on certain commodities are highly inefficient as a method of improving income distribution. This is clear from the data in Appendix 9 which show that a very low proportion of total expenditure on necessities is accounted for by the poor.

5.24 Expenditure on zero-rated food, clothing and footwear amounted to almost £1,700 million in 1983. Taxation on this expenditure would raise a sum far in excess of what would be necessary to compensate the poor for the regressive impact of a general value-added tax. We must now consider, however, how relief could be directed to those people who would be in need.

5.25 If 'necessary' items are included in the tax base it may be possible to offset the regressive effects that follow by taking compensatory action in other areas of the taxation system or through changes in public expenditure. We considered a number of schemes:

- (i) the use of the existing personal income tax machinery to allow certain individuals and families a credit for value-added tax (up to a specified amount on selected goods), with a refund of tax if the credit exceeded the income tax liability. The concept here is related to that of negative income tax. In view of our rejection of this concept in our first report⁷, we did not consider this scheme any further,
- (ii) the use of stamps, or coupons, which would either be issued by retailers to consumers in proportion to their purchases and would

⁷Paragraph 23.20.

be redeemable up to a certain sum annually, or would be issued directly to consumers by government. We rejected both schemes on administrative grounds,

- (iii) the introduction and extension of direct food subsidies for key necessities such as specified food stuffs. The main disadvantage of this approach, like zero-rating, is that subsidies, applying as they do irrespective of individual need, do not sufficiently discriminate in favour of the less well off sections of the community. Consumer subsidies in Ireland on the three principal products covered at present — butter, milk and bread — cost the Exchequer just under £100 million in 1983. Our analysis⁸ of the zero-rating of food generally suggests that the greater portion of this sum benefits those who are least in need of assistance. Rather than providing reliefs in this indiscriminate manner it would be far more sensible to place cash payments in the hands of the poor, and
- (iv) the payment by the government of allowances through the social welfare system to low income consumers who are obliged to spend a substantial percentage of their income on 'necessities'. This scheme presents the advantage of greater selectivity. It would provide assistance to those in need and no one else. To reach all people in need requires a well-developed and efficient social welfare system.

5.26 We believe that an active social policy of granting social welfare benefits to people in need of them would be more effective in achieving equity than the use of an indiscriminate instrument like zero-rating which distributes benefits to everybody, in the hope that some of the benefits will find their way to those in need.

Higher Rate and Equity

5.27 It was submitted to us that the rates of value-added tax on luxury and non-essential goods should be increased and that clearer distinctions should be drawn between luxuries and necessities. This view is based on the argument that there are certain goods and services which are bought mainly by the higher income groups and that such goods should be subject to higher taxation to make the tax system more progressive. Even if luxuries are narrowly defined as being those goods and services which are mainly consumed by the high income groups, it is very difficult to identify such goods for tax purposes. Heavier taxes on luxury goods are unlikely to contribute much to progressivity, unless the designated goods are frequently changed to reflect the changing tastes of persons in the higher

⁸ Appendix 9.

income groups and to take account of the fact that today's luxuries are tomorrow's necessities. Such taxes are also much more likely to be borne by the producers of these goods than taxes on essentials which can be shifted more easily to consumers.

5.28 On the question of equity we consider that progressive taxation of expenditure is best achieved by a direct tax on expenditure on the lines proposed in our first report. Furthermore, as already stated, we believe that it is the overall progressivity of the tax and public expenditure systems which is important from the point of view of achieving equity, not the position in relation to individual taxes or expenditure schemes. Progressivity in the tax system can be achieved through the direct tax system; a major contribution to equity must also come from public expenditure.

EFFICIENCY

5.29 Exemptions and differential rating distort the pattern of consumption and ultimately of production. When the price of a specific product is made cheap relative to the price of goods generally, through the application of a zero rate or reduced rate of tax, the demand for it rises above the level that would prevail in the absence of special measures. Resources are then pulled from other productive areas to meet the artificially created demand. This is wasteful unless it compensates for market imperfections.

5.30 On grounds of economic efficiency it is desirable that the indirect tax system should take account of the needs of industrial policy. One aspect of industrial policy relates to the development of products for export with higher value-added. A thriving home market is essential in order to develop these products. High rates of indirect tax on specific products could inhibit the development of such goods by reducing their home market.

THE WIDENING OF THE TAX BASE

5.31 The scope for broadening the existing sales tax base must be examined. We do so by looking at those areas of personal consumption which are not taxed at present and into which the tax might be extended. In doing so we are conscious that most of the existing rates of VAT are much too high. We put forward our recommendations for extending the tax base solely on the basis that these rates are reduced to a sustainable level. Even if the rates of VAT on certain items are reduced, low income consumers would have to be compensated through the social welfare system for the changes brought about by the impact of our proposals, particularly in relation to the taxation of expenditure on food. However, we believe that a greater contribution to equity can be made by charging all goods to value-added tax and providing assistance directly to those in need. Increases in social welfare payments and children's allowances are the most efficient

way of doing this. In other areas, policies on housing, transport, education, cultural development and other matters affected by the changes we propose will have to be examined and alterations made where necessary.

Zero-rating and Exemption

5.32 Before considering the value-added tax base we look briefly at the ways in which goods and services may be freed of value-added tax. In practice, goods may be zero-rated or exempt.

5.33 Zero-rating is the most favourable treatment available under VAT. It means that sales of zero-rated goods bear no tax but the supplier may claim deduction or repayment for any tax paid on his inputs. The zero rate completely eliminates the value-added tax on a product or service. The following are some of the more important items which are zero-rated: most items of food for human consumption, except alcoholic drinks, ice-cream, chocolate, soft drinks and potato crisps; children's clothing and footwear; medicine for human oral consumption; electricity; books and certain farm inputs. The export of goods and certain services connected with the export of goods are also zero-rated. The zero-rating of exports, which applies throughout the European Community, ensures that there is no distortion in trade competition between EEC member states as a result of VAT. Goods produced in Ireland can compete in EEC markets on the same basis as goods produced in other EEC countries.

5.34 Exemption means that, as with zero-rating, no tax is imposed on the sale or supply of an exempt good or service, but in this case no credit is allowed for the tax on inputs. In contrast to the zero rate, an exempt transaction bears some VAT. Tax is charged on purchases of the exempt supplier which is ultimately passed on to the consumer, for example, the VAT paid by banks on the purchase of buildings, office equipment and services is reflected in the cost of financial services which are exempt from VAT. The other principal exemptions relate to education and health services, insurance and reinsurance transactions, betting subject to certain conditions and limitations, telecommunications services and passenger transport.

Food

5.35 Food has been zero-rated since September, 1973. This results in severe erosion of the tax base (expenditure on food accounts on average for almost 28 per cent of personal consumption) and consequently in much higher rates of tax on other items.

5.36 The aim of the zero-rating of food is to reduce the regressive impact of a general value-added tax on the lower income groups. However, from

our earlier analysis of the income distribution effects of zero-rating we see that the greater share of the benefits in absolute cash terms goes to the better off. This is inefficient and wasteful. We recommend that food be charged to value-added tax.

Clothing and Footwear

5.37 VAT has been charged at 8 per cent on clothing, other than clothing for children under eleven years, and on clothing materials since 1 May, 1984. Prior to that, most personal clothing and clothing materials were zero-rated. Footwear has been zero-rated since 1975. The data in Appendix 9 reveal that expenditure on clothing and footwear actually increases as a proportion of expenditure as expenditure rises. Because of this, an even greater share of the tax foregone through zero-rating or reduced rates goes to the better off than in the case of food. Moreover, there are no practical difficulties associated with the taxation of clothing and footwear. Accordingly, we recommend that expenditure on clothing and footwear be subject to value-added tax at the single rate.

5.38 We considered the question of the taxation of expenditure on children's clothing. The data in Table 9.3 in Appendix 9 suggest that a tax on this category of expenditure would not be regressive. Exemption of such clothing from VAT is a wholly inefficient method of helping those in need. Any arbitrary classification of children's clothing gives rise to inequalities. We consider in these circumstances that children's clothing does not warrant continued exclusion from the tax base. We recommend that value-added tax be applied to all expenditure on clothing.

Oral Medicine

5.39 At present only oral medicines are zero-rated for value-added tax purposes; all other medicines are charged at 23 per cent, excluding goods which are categorised as soaps, shampoos, detergents, bleaches, germicides, insecticides, antiseptics or disinfectants, which are charged at 35 per cent.

5.40 The Revenue Commissioners advised us that

"In order to reduce the difficulties and complexities the classification of the goods to which a rate applies must sometimes be extended beyond the scope of the original intention. The relief for food, for example, includes oral medicine."

5.41 We do not favour the exclusion of oral medicines from taxation or, indeed, for that matter any other type of medicine. While some outlays on drugs and other medical products have to be made by most consumers, these normally account for a relatively modest portion of expenditures.

However, we do accept that there are people who are compelled, by circumstances over which they have no control, to spend very considerable amounts on these products. With a general sales tax these consumers would have to bear a disproportionate share of the tax burden because of their state of health, irrespective of their financial circumstances. We believe that these people should be assisted directly by the state. We also believe that the most effective and efficient way to do this is not through the general exemption from taxation of all medicines or even certain groups of medicines which could extend into the area of unnecessary and 'fringe' pharmaceuticals, but rather through direct monetary payments to the people concerned via the Department of Health or the Department of Social Welfare. Indeed such schemes are already operated by regional health boards. We, therefore, recommend that oral medicines should be charged to value-added tax.

Electricity

5.42 The supply of electricity is zero-rated. However, the ESB informed us that electricity is subject to taxation as follows:

- (i) the current excise duty on hydrocarbon oils to the ESB is £15.5 per tonne compared with £10 per tonne paid by industry. Total payment of excise duty costs the ESB some £11 million per annum. The hydrocarbon excise tax was introduced some years ago at the time when value-added tax was removed from fuels, including electricity,
- (ii) there is a special levy in lieu of rates on stations and networks. The ESB has always paid rates on general properties such as offices, shops, stores, workshops etc. It never paid rates on its stations and networks until 1982 when £10 million was paid to the Minister for the Environment in accordance with the provisions of the Electricity Supply Amendment Act, 1982. The sum to be paid is determined on an arbitrary basis and amounted to £20 million for 1983,
- (iii) currency losses are incurred on foreign borrowings. The ESB is 'encouraged' by the Department of Finance to borrow in foreign markets — though adverse currency losses are not allowable for tax purposes. However, where the ESB invests in foreign securities — with the approval of the Department of Finance and the Central Bank — to provide funds towards the repayment of foreign borrowings, capital gains tax is chargeable on the appreciation of the value of investments which arises primarily from devaluation of the punt.

5.43 Many of the recommendations in our first report would ease these problems. We have recommended that rates paid be allowed as a credit against income tax liability. Currency losses, like all other losses, come within our definition of income and would be allowed as a deduction for tax purposes. We recommend the removal of the hydrocarbon oil tax in Chapter 12.

5.44 In addition to the above taxation, the ESB stated that electricity consumers are subject to hidden taxation in the form of additional costs imposed by government. These additional costs⁹ are ultimately passed on to the consumer. The National Prices Commission in its monthly report, July 1982, noted that "two factors, viz (i) the obligation to purchase fuel oil from INPC at a premium price, and (ii) substantial increases in peat prices are significant contributors to increasing electricity charges". Where this hidden taxation is passed on to commercial and industrial users of electricity (and 50 per cent of the Board's revenue arises from these sources) they are not in a position to reclaim the tax as would be the case if value-added tax applied. This raises industrial costs, penalises exports and subsidises imports. We consider that this situation should be remedied. We recommend that electricity be charged to value-added tax. This would not raise industrial costs.

⁹ The ESB informed us that electricity consumers are subject to hidden taxation in the form of additional costs imposed by government in the following ways:

- (i) the ESB is obliged to buy fuel from the Irish National Petroleum Corporation, Bord na Móna and Bord Gáis Éireann at above market price. The purchase of oil from the Irish National Petroleum Corporation involves additional costs of £7 million per annum. The use of peat is currently costing £17 million above oil prices and in the period from 1958 to 1982 the total additional costs of the use of peat amounted to £143 million above oil prices. Gas is cheaper than oil but it is not being purchased at a competitive market price by the ESB. The ESB argues that it is paying £70 million to £80 million per annum in excess of the price it could negotiate in the absence of Government intervention,
- (ii) the ESB obtains no benefit from the interest subsidy on European Investment Bank Loans. The Board pays full commercial rate of interest; a 3 per cent subsidy is paid to the Exchequer in the form of a grant under the terms of the European Monetary System. While the Board may not have an absolute right to the "Interest Subsidy", the obligation to borrow from the European Investment Bank involves the Board in additional costs via the enforced timing, structure and currencies of the borrowings. Italy is the only other EEC country where a similar subsidy applies. The Italian Government passes the benefit of the subsidy through to its domestic utilities,
- (iii) EEC (Feoga) grants in connection with certain projects are reduced. In general only 50 per cent of the amount of these grants is passed on to the ESB by the Exchequer. The revenue loss amounts to approximately £800,000 per annum,
- (iv) there is the additional cost of awarding certain contracts to Irish companies in pursuit of a policy of support for Irish industry. The costs involved here are estimated at £5 million per annum, and
- (v) costs are incurred on the Rural Electrification scheme which is funded in effect by a cross subsidy of some £10 million from urban to rural consumers (not necessarily farmers).

Books

5.45 The Minister for Finance in his 1982 budget speech stated "I have been concerned for some time about the application of VAT to books, especially school books. The proposed new rate of 18 per cent (now 23 per cent) would be particularly severe in this area, so I propose to move all books to the zero rate of VAT from 1 May, 1982." This is yet another example of increasing rates of VAT contributing to the further erosion of the tax base.

5.46 Under the provisions of the Sixth Directive on value-added tax a member state of the European Community may only maintain zero-rating during the transitional period for those goods and services which were zero-rated at 31 December 1975. The zero-rating of books was introduced after 31 December, 1975. Infringement proceedings have therefore been initiated by the Commission of the European Communities.

5.47 Apart altogether from the problems in relation to Ireland's obligations to the EEC, we see little justification for this measure. It discriminates against other goods not as favourably treated and the benefits accrue mainly to the better off. Of every £100 spent on books only £6 is spent by the poor (i.e. the bottom two income groups). While the purchase of school books and text books may bear heavily on students and their parents, any relief for VAT would have to apply indiscriminately. We recommend that the zero-rating of books be abolished and that they be charged to value-added tax.

Treatment of Farmers and Farm Inputs

5.48 The following goods are also zero-rated:

- (i) animal feeding stuff (excluding feeding stuff for domestic pets),
- (ii) fertiliser which is supplied in units of not less than 10 kilograms,
- (iii) medicine of a kind used for animal oral consumption (excluding medicine for domestic pets), and
- (iv) seeds, plants, trees, etc. of a kind used to produce food.

The treatment of animals by veterinary surgeons is exempt and certain agricultural services and farm accounting and farm management services are charged to VAT at a special reduced rate of 5 per cent.

5.49 When value-added tax was introduced in 1972, some animal feeding stuff and mineral mixtures were zero-rated. In addition, unregistered farmers were compensated for the tax paid on purchases by means of a 1 per

cent addition to the prices at which they sold their product. The 1 per cent added was deductible from the value-added tax payable by the farmer's customers. This scheme, which is described in detail in Appendix 5, kept farmers within the value-added tax system, but did not require them to file a tax return. In effect, the deduction which would otherwise have been available to the farmers was passed on to their customers.

5.50 In 1973, the positive rates of value-added tax were increased. Normally, this should have given rise to an adjustment in the addition to farmers' prices to reflect the increased value-added tax imposed on farmers' purchases. However, instead of increasing the 1 per cent refund, zero-rating of farming inputs was extended. The Minister for Finance in making this change stated that

"Rather than revise the 1 per cent addition, to which farmers have become accustomed, I decided to extend the zero-rate, which at present applies to manufactured fertilisers and feeding stuffs, so as to cover unprocessed feeding stuffs, such as green grains, and to animal oral medicines as well as seeds and plants for the production of food. These reliefs are calculated to be ample to bring down farmers' input tax to a level of 1 per cent of total farm output. The present 1 per cent addition can, therefore, remain undisturbed."¹⁰

On all other occasions¹¹ when value-added tax rates affecting farmers' purchases were increased, the addition allowed to farmers was adjusted also. The addition to the prices at which farmers sell their produce is currently 2 per cent.

5.51 The question of how farmers should be compensated for the tax on their purchases involves consideration of whether or not farmers should be required to register for VAT.

5.52 In 1972, farmers were excluded from the normal value-added tax scheme. They were not obliged to register for VAT but they could register if they wished. At that time farm profits were exempt from income tax; consequently, farmers in general did not maintain accounting records. The majority would not have had the detailed records necessary for a value-added tax return. Since 1983 all farmers are chargeable to income tax on farming profits and are required to maintain accounting records. Therefore, farmers need no longer be left out of the normal value-added tax scheme solely because they do not have adequate records. However, at present the

¹⁰ Dáil Debates Vol. 267 Col. 680.

¹¹ The flat-rate relief for purchases from unregistered farmers was discontinued on 1 March, 1976, but was restored on 1 March, 1979. This temporary withdrawal of the tax credit was part of a special measure to fund a scheme to subsidise the cost of cattle feed to small farmers during those years.

output of farmers is, in the main, chargeable at the zero rate¹². Most farmers, therefore, if registered, would have little or no liability. The volume of repayments which would arise every two months would put severe strain on the administration and the result would be long delays in dealing with repayments to farmers.

5.53 In principle, all farmers should be registered for VAT. This would require them to account for tax and file returns. However, since there are about 150,000 farmers in Ireland, the full operation of VAT would be costly and difficult. Because farmers sell mainly to food processors, wholesalers and other taxable persons, the problem cannot be solved by fixing an exemption level as is appropriate for small retailers who sell to final consumers. To provide an exemption for small farmers would deprive their trade customers of a deduction for tax paid by the farmers on their inputs. This would introduce a bias against farmers who were not registered for VAT, unless compensating measures were introduced.

5.54 Compensating unregistered farmers for tax on inputs could be achieved by an addition to the prices at which they sell their produce as at present. However, if the current zero-rating of animal feeding stuff, animal oral medicine, fertilisers and seeds were abolished, the existing compensation would have to be increased. Nevertheless, the cash flow of certain unregistered farmers could be reduced because the compensation would only be paid to farmers when their produce or livestock was sold. In the interval, the input tax would have to be financed by the farmer. However, other farmers would benefit if the existing practice were followed of adjusting the addition to prices at the same time as the inputs were charged to tax, since they would obtain compensation for inputs bought before the tax charge came into operation. The extent of the effects on cash flow would depend on the cycle of sales of farm output. While the problem of cash flow arises to some extent at present, it would be aggravated if all inputs were charged to value-added tax.

5.55 On balance, we consider that the present system of allowing farmers the option to register for VAT should be retained. This would entail a continuation of the scheme of a flat-rate addition to prices for unregistered farmers to compensate them for the tax on their farm inputs. The problem remains whether the zero-rating of animal feed stuff, animal oral medicine, fertiliser and seeds should be retained. Those farm inputs which are zero-rated at present are readily identifiable and are clearly defined in the legislation. By and large they are used by farmers and not final consumers.

¹² An effective rate of 2 per cent applies to sales of live cattle, sheep and pigs by registered farmers. This is to ensure that there is no distortion of trade between registered and unregistered farmers. It also prevents abuse of the system of compensation to unregistered farmers and simplifies the administration of VAT for farmers generally.

The effect of zero-rating these inputs under our proposals would be to defer the VAT charge until the output produced was sold by a registered person. The registered person could be a farmer who had opted for registration or a wholesaler or retailer involved in the distribution of agricultural produce who had acquired his stocks from unregistered farmers. There would be no loss of revenue. In the circumstances, we favour the continuation of zero-rating of animal feed stuff, animal oral medicine, fertilisers and seeds.

5.56 We recommend that farmers retain the option to register for value-added tax. Where farmers choose to remain unregistered they should be compensated for the tax on their inputs by means of a flat-rate addition to prices. The existing zero-rating of animal feeding stuff, animal oral medicine, fertilisers and seeds should be retained so long as this is compatible with obligations under the Sixth Directive.

Building and Associated Services

5.57 Most goods and services supplied by building contractors and other contractors operating in the building sector are liable to value-added tax at a special reduced rate of 5 per cent¹³. The special rate of value-added tax applies to housebuilding and construction work generally; to building renovation and demolition; to building maintenance and repair; to the installation of plumbing, heating and electrical services and to the supply, installation, maintenance and repair of fixtures¹⁴ (but not fittings).

5.58 As a general rule, property does not attract liability to VAT unless all of the following conditions are satisfied:

- (i) the property must have been developed or re-developed in whole or in part after 31 October, 1972,
- (ii) the vendor must hold the freehold interest in, or a leasehold interest of at least ten years in, the property,
- (iii) the vendor must dispose of the freehold interest or an interest of 10 years or more,

¹³ Prior to 1 May, 1983 building and associated services supplied by registered contractors were liable at an effective rate of 3 per cent. The actual rate, and the rate that was required to be shown on VAT invoices was the low rate (23 per cent) but the low rate was charged on only a percentage of the contract price.

¹⁴ Fixtures are goods which have been attached to buildings in such a way that they cannot be removed without substantial damage being caused to the goods themselves or to the buildings to which they are attached. In the case of houses, fixtures could, as a general rule, be said to include the basic items normally to be found in a new, unfurnished, standard house.

- (iv) the disposal must be made in the course or furtherance of business, and
- (v) the vendor must have been entitled to (as distinct from having received) a VAT credit or deduction in respect of the development of the property or the acquisition of the interest referred to above.

5.59 The general effect of the VAT provisions in relation to property transactions may be summarised as follows:

- (i) a VAT charge arises on the first sale or long-term leasing following the construction of a building irrespective of whether the sale is to an accountable trader, an exempted trader or a private person,
- (ii) if the buyer is an accountable trader, he is entitled in the ordinary way to an input tax credit for the VAT paid to the builder, which is deducted from the tax for which he is accountable on his own business sales,
- (iii) if a trader acquires property in circumstances in which he is entitled to an input tax credit, then any subsequent disposal by him of the property will be chargeable to tax, and
- (iv) if property passes to a person who is not entitled to an input tax credit, it passes out of the VAT system and tax will not be chargeable in respect of any subsequent sale, unless an event occurs to bring it back into the system again. This will only occur if the property is developed and the conditions in paragraph 5.58 are met.

5.60 The reason for the special rate of tax on building services goes back to the turnover and wholesale taxes which preceded VAT. When VAT was introduced in 1972, this was done on the basis that while the system of taxation was being changed, the incidence of tax would be the same—hence the rather unwieldy rates of 5.26 per cent, 16.37 per cent and 30.26 per cent which were adopted.

5.61 Prior to 1972, building and construction was not chargeable to sales taxes, but a wide range of important building materials, notably timber, glass, paint, piping and sanitary fittings were liable to both wholesale and turnover tax. However, certain basic building materials such as earth, stone, gravel, sand, cement, structural steel and roofing tiles were exempt. It was estimated that sales taxes on building materials contributed, on average, about 3 per cent of the selling or contract price of a building inclusive of the cost of the site. To maintain the existing incidence of taxation on building services only 60 per cent of the volume of such services

was charged to tax at the low rate of 5.26 per cent. this resulted in an effective rate of 3.156 per cent on building services. While the low rate of VAT was increased on five occasions since 1972 to its present level of 23 per cent, the special rate of tax on building services was only increased once to 5 per cent on 1 May, 1983.

5.62 Strictly speaking, consumption of building and construction services should be measured by the annual rental value of buildings occupied. Value-added tax should be levied at the normal rate on this sum. This approach would be difficult, if not impossible, to apply in practice. The alternative is to charge the capital value of a building, which would include the value of the site, to value-added tax on its completion, since the capital value represents the discounted present value of the future income (rent) from the building.

5.63 The question arises as to whether or not VAT should apply to the unimproved value of sites. In principle, the unimproved value of a site should not attract a charge to value-added tax. It would be almost impossible to estimate the improvement in value with any precision and disputes which would be difficult to settle would arise between taxpayers and the Revenue Commissioners. However, it would be possible to exclude a fixed proportion of the value of a site from the taxable base. This is done in France where the taxable value of building sites is reduced by 30 per cent.

5.64 A problem arises where a person owns or acquires his own site and erects a building on it. It would be difficult to charge VAT on the full value added. This would mean imposing a charge on the improvement in value of the site, whether it was already owned prior to the development or acquired by purchase, and would involve a charge on the full value of the building, whether it was constructed by the owner or by a building contractor. Yet, if this were not done there would be a distortion in favour of those who build their own houses. This distortion would be greatest where the construction work is done on a do-it-yourself basis because VAT would only be payable on the materials purchased. Where the work was carried out by a building contractor registered for VAT, tax would be payable on the full contract price. While no firm evidence is available, it seems likely that the vast majority of single private houses are built by building contractors. Other do-it-yourself operations are disregarded for both income tax and value-added tax and it would be very difficult to justify an exception to this for housing. However, there must be an attempt to minimise the distortion in the treatment of site value in the case of a single private house and, for example, an estate house bought from a developer. This is impossible to achieve fully in practice, particularly in cases in which people build a house on their own lands.

5.65 There is no easy answer to the problem of charging all sites to VAT. The administrative difficulties of treating all such transactions as chargeable

for VAT purposes are formidable. Even if the tax were confined to those sites which were acquired separately by purchase the difficulties would remain. A reduction in the taxable value of sites by reference to the unimproved value of the land would reduce any inequality in the tax treatment of different houses.

5.66 A further point which must be considered is the treatment of fixtures for VAT. The existing distinction between 'fixtures' and 'fittings' gives rise to some curious results. For example, if an item is considered to be a fitting, as distinct from a fixture, the full rate of VAT (usually the standard rate) is charged. A plumbed-in washing machine (fitting) would be charged at the standard rate (35 per cent), while a fitted kitchen (fixture) would qualify for the special rate (5 per cent). Nonsensical distinctions of this kind also lead to evasion. The possibility exists of sales being returned at the special rate instead of the low or standard rates where an item has been supplied but not fitted.

5.67 We recommend that building-related services and property transactions already within the scope of VAT be charged to VAT at the same rate as other goods and services, subject to a fixed reduction in the chargeable value of sites by reference to the unimproved value of land. Building land should be charged at the single rate subject to a similar reduction by reference to the unimproved value of land.

Rented Accommodation

5.68 In general, VAT is not chargeable on rents of property unless the person in receipt of the rents elects to be taxable on them¹⁵. This option is provided under the Sixth Directive. If he does elect he becomes taxable on all such rents, excluding those payable under leases for a term of 10 years or more. Rents of property, when chargeable to tax, are chargeable in full at the low rate (23 per cent). A person who waives his exemption and elects to be taxable on rents receivable and who subsequently wishes to cancel his waiver may do so only by refunding any excess of tax repaid to him over tax paid by him.

5.69 An individual tenant renting a house or apartment for residential purposes clearly benefits from not having to pay value-added tax on the

¹⁵ The following rents are taxable whether or not an election to pay tax has been made:—

- (i) Rents of machinery or business installations, when let separately from the premises of which they form part. Thus, a rent charged for, say, a lift would be taxable even though the lift would technically be regarded as a fixture in the premises in which it was installed;
- (ii) The letting of rooms, garage space, parking space or other accommodation in the course of carrying on a hotel business;
- (iii) The provision of parking accommodation for vehicles by the operators of the car parks; and
- (iv) The hire of safes.

rent. But a taxable person would prefer to pay value-added tax on space rented for business purposes since it would be deductible in computing his VAT liability. If the rent were exempt, there would be no deduction, even for the value-added tax on the materials used to construct the rental space. Whether the rents are or are not chargeable to value-added tax is in theory a decision that now rests solely with the landlord because of the option granted to him in relation to the exemption of rents. In practice, people are unlikely to elect to be taxed on rents, as they could then be liable for value-added tax on the sale of the property.

5.70 In view of the fact that we have decided that the imputed value of owner occupation should not be subject to income tax and that mortgage interest is not subject to value-added tax, we feel that rented residential accommodation, in general, should continue to be exempt from value-added tax.

THE SIXTH DIRECTIVE

5.71 The EEC Sixth Directive limits strictly Ireland's freedom to depart from the uniform basis of assessment adopted by that directive. This prohibits the charging of value-added tax on education, hospital and medical care, financial services and insurance and reinsurance transactions including related services performed by insurance brokers and insurance agents. We accept that these services must continue to be exempt from value-added tax.

5.72 The Sixth Directive also exempts betting, lotteries and other forms of gambling "subject to conditions and limitations laid down by each member state". The Finance Act, 1980 restricted the scope of the exemption for betting to bets liable to excise duty and bets at horse and greyhound races. This restored the charge of value-added tax to receipts from certain gaming machines which the courts had ruled to be betting and, therefore, exempt. We deal with the taxation of betting in Chapter 11.

5.73 Certain goods and services remain exempt from value-added tax in Ireland even though they will be taxed under the final scheme set out in the Sixth Directive. In the normal course, there will be a considerable delay before this final scheme is fully in operation. We now examine these exemptions and consider whether they should be abolished in the near future.

Admission to Sporting Events

5.74 This exemption favours one form of recreation. It discriminates against all others where value-added tax is charged e.g. cinemas. Furthermore, the richest households spend five times the amount in absolute terms spent by the poorest households on admissions to sporting events. We

recommend that the present exemption be abolished and that admission charges to sporting events be charged to value-added tax. The registration limits for VAT are sufficient to ensure that small events are unaffected by this change.

Supply of Greyhounds and Horses

5.75 In principle, we consider that these transactions should be charged to value-added tax. However, we are aware that there are unavoidable difficulties involved in the valuation of these animals for tax purposes and other practical difficulties because of the nature of the trades. When introducing¹⁶ the exemption the Minister for Finance stated

"It is a necessary part of the operation of the bloodstock and greyhound industries that animals are frequently exported and imported for varying periods, and it was found that the operation of VAT on importation was seriously affecting the smooth functioning of the industries. The exemption here proposed will solve the problem."

We endorse this approach.

Telecommunications Services

5.76 We see no justification for the exemption of telecommunications services from VAT. Since such services are exempt, the telephone company gets no credit for value-added tax paid on its inputs. The tax is trapped and the additional costs are passed on to purchasers of telephone services. Registered persons would prefer to pay value-added tax on telecommunications services for business purposes, since they would be able to obtain a credit for any tax paid. Under the present exemption there is no deduction, even for the value-added tax on the materials and equipment used in the provision of the services. Since telecommunications services are a significant cost to business, the imposition of VAT would lead to an increase in economic efficiency. We recommend that the exemption of telecommunications services be abolished and that in future value-added tax be charged on all such services.

Passenger Transport

5.77 Passenger transport is now exempt from VAT. In principle, we see no case for its continued exemption. However, the main supplier of passenger transport services, Córas Iompair Éireann, is in receipt of a substantial subvention from the taxpayer. On the basis that the rates and fares charged are already as much as the market will bear, it might be argued that the imposition of VAT would merely result in an increase in the subvention commensurate with the revenue raised. Despite this there are other factors which must be taken into account.

¹⁶ Dáil Debates Vol. 267 Col. 681.

5.78 The present exemption does not free passenger transport services from VAT. As the operator of an exempt service, Córas Iompair Éireann is unable to reclaim the input tax on goods and services purchased for both rail and road passenger services. At present, input taxes incurred in day-to-day operation of passenger road and rail services amount to £7-8 million per annum. With receipts from these services amounting to approximately £153 million, the failure to recover input tax is equivalent to a rate of between 4.8 per cent and 5.5 per cent on receipts. The level of input tax varies depending on the level of capital investment in infrastructure and renewals of rolling stock and buses each year.

5.79 While the carriage of passengers is exempt from VAT, freight services are chargeable at the low rate. This causes particular difficulties for CIE in accounting for VAT. The input tax on any item is only deductible if the item is used for the purposes of the taxable activity, that is, freight services. The use of all plant, equipment and parts has to be monitored to establish entitlement to a deduction for the input tax. Where equipment or parts are used for both the taxable activity and the exempt activity, the input tax has to be apportioned. This apportionment is normally made on the basis of the ratio of freight receipts to total receipts in the year of purchase. The operation of this system is reviewed regularly by the Revenue Commissioners and CIE.

5.80 A charge to VAT would allow CIE to recover automatically the input tax on its purchases relating to passenger transport services. It would also simplify the operation of VAT in this area for CIE and the Revenue Commissioners. It would, in addition, show the true subvention to CIE and thus enable policy makers to assess the needs and benefits of public transport more accurately.

5.81 A further reason for a charge to VAT on passenger transport is that a tax on train and bus fares would if passed on to the final consumer, not only in absolute terms, but also as a proportion of total expenditure, bear less heavily on lower and lower middle-income households than on higher income households.

5.82 We recommend that VAT be applied to passenger transport charges in respect of journeys in the state.

5.83 Passenger transport by air and by ship (i.e. in the main travel outside the state) is also exempt from value-added tax. However, this form of travel is subject to a foreign travel tax levied on all air and sea tickets purchased in the state. In principle, we favour the extension of value-added tax to all forms of passenger transport and the abolition of the present foreign travel tax. However, there is a need to take account of the fact that passenger transport is zero-rated in the United Kingdom. This issue is considered further in Chapter 12 in our examination of the foreign travel tax.

The Services of Travel Agents for Journeys within the European Community

5.84 A special scheme for travel agents was devised by the EEC. This is set out in Article 26 of the Sixth Directive. Under the scheme a uniform system for taxation has been determined. At the final stage of harmonisation it is envisaged that remuneration which travel agents receive from journeys made outside the Community will be exempt from VAT, whereas remuneration which travel agents receive from journeys made within the Community will be taxed. However, during the transitional period, member states are free to derogate from the provisions concerning travel agents. At present travel agents in Ireland are exempt in respect of all transactions. We recommend that steps be taken to bring about a situation whereby the revenue of travel agents in respect of journeys made within the European Community is charged to value-added tax.

OTHER RELIEFS

5.85 There are a number of other small reliefs for value-added tax. In examining these the principles are clear. Exemptions encourage inefficiency and waste resources by distorting consumer choices. They are unfair. Desirable income distribution effects can be achieved much more efficiently by measures other than indiscriminate tax reliefs. Finally, exemptions complicate the administrative system, increase compliance costs and facilitate tax evasion. We believe they are wholly undesirable and should be removed.

Foreign Tourism Revenue

5.86 In a submission to us Bord Fáilte stated that "value-added tax on sales of goods and services to tourists in Ireland is charged as for any domestic sale. Thus tourists pay 18 per cent tax on most accommodation and 35 per cent on many of the items which they buy. Were these goods and services to be exported in the normal way so that the point of sale lay outside the state, they would be exempt as an implicit incentive directed at improving the balance of payments. Tourism revenue contributes to the economy in an identical manner, but is not encouraged by VAT exemptions.

The effects of dropping VAT from certain areas would be highly favourable. Tourists face very high prices in Ireland at present, and elimination of VAT from restaurant meals and possibly accommodation would have a beneficial impact. Accommodation for large conferences suffers from uncompetitive pricing, when compared with major European centres, and this is one highly profitable area which could be considerably developed by a VAT reduction".

5.87 The principles here are clear. Exports are free of VAT and this should

also apply to export of services. Therefore, services provided to visitors to Ireland should be free of VAT. However, a distinction must be drawn here between visitors from another member state of the EEC and visitors from outside the EEC. In the case of services provided to visitors from EEC countries, it would be sufficient to relieve them of VAT to the extent that rates of VAT are higher here than in their home countries. It would be impossible to implement this in practice, due to the difficulty of differentiating between categories of visitors and between services provided to visitors and those provided to Irish residents. To attempt to do so for all services provided to visitors would lead to intolerable administrative problems and facilitate widespread tax evasion. However, a scheme introduced on 1 March, 1984 provides relief from VAT, subject to certain conditions and limitations, in respect of goods purchased by visitors to this country for export. Details of this scheme are in Appendix 10. We do not recommend any further reliefs for foreign tourists. Services provided to foreign tourists should be subject to VAT at the single rate.

5.88 At this stage we think it important to point out the beneficial effects on tourism of our other recommendations. Being a labour-intensive industry, the removal of employers' social insurance contributions on the basis of payroll costs would be particularly helpful to the industry. In addition, the allowance of rates as a credit against tax liability should assist the industry. Our proposals would also result in a reduction in the rate of VAT applied to tourism. These measures should create a good fiscal environment for the development of tourism.

5.89 The question arises whether compensatory measures should be taken to offset the burden of VAT on export tourism. This is an issue which is outside our brief. However, we would draw attention to the fact that state expenditure on tourism is estimated to be £31.8 million in 1983.¹⁷

Business Expenses

5.90 Businesses registered for VAT are entitled to take credit for the VAT paid by them (input tax) on expenditure incurred for business purposes. There are a number of exceptions to this rule in that input tax on the following business expenses is not deductible:

- (i) the provision of food or drink, or accommodation or other personal services for a taxable person, his agents or employees,
- (ii) entertainment expenses incurred by a taxable person, his agents or employees,
- (iii) the acquisition (including hiring) of passenger motor vehicles otherwise than as stock-in-trade (that is, for re-sale) or for use in a vehicle hire or driving school business, and

¹⁷ Comprehensive Public Expenditure Programmes Pl. 1637 p. 101.

- (iv) the purchase of petrol otherwise than as stock-in-trade (that is, for re-sale).

5.91 In our first report, we concluded that motor expenses and entertainment expenses incurred wholly, exclusively and necessarily for business purposes should be allowed in full in computing the profits of the business entity. In principle, the same approach should be adopted in relation to VAT. This would also be in line with the principle of VAT that any trader should be able to deduct from the tax on his turnover any tax on expenditure necessary for the operation of his business. The present treatment results in tax being trapped at an intermediate stage. This makes Irish businesses less competitive where exports are not completely free of VAT.

5.92 Another principle of the VAT system is that any expenditure which constitutes final consumption should be subject to tax. The categories of expenditure excluded from the right to deduct input tax all have the characteristics of final consumption. The difficulty arises because the expenditure is, in whole or in part, final consumption and is incurred in connection with the operation of a business.

5.93 The disallowance of input tax on motor vehicles, petrol, food and drink, accommodation and entertainment expenses avoids or greatly simplifies those cases where a distinction has to be made between expenditure destined for final consumption and expenditure which is necessary for the operation of a business. This facilitates the task of the Revenue Commissioners and is intended to reduce or prevent tax fraud.

5.94 In EEC countries the existing exclusions from the right to deduct input tax are extremely varied. In January, 1983 the Commission of the European Communities presented to the Council a proposal for a directive to harmonise the different practices and to overcome the potential distortions of competition. The proposed Twelfth Directive provided that deduction of input tax should be prohibited on expenditure relating to passenger cars, pleasure boats, private aircraft and motor cycles; business travel; accommodation, food and drink and entertainment, amusements and luxuries. Following discussion of the proposals in the European Parliament, a number of amendments to the original proposals have been adopted. Businesses and taxable persons registered for VAT would be able under the revised proposals to reclaim half the VAT paid on passenger cars, motor cycles and transport costs. If proof can be provided that no private element is involved in the use of cars, boats or aircraft and business trips, then all the VAT could be reclaimed. VAT would be fully refundable on any cars, boats or aircraft held as stock-in-trade of the business, for example, on cars used by vehicle hire concerns or for training purposes.

5.95 In principle, we favour a full deduction for input tax on expenditure

incurred wholly exclusively and necessarily for the purposes of the business. Strictly speaking, the deduction should be apportioned where there is an element of private or non-business use. Apportionment on an individual basis would give rise to administrative difficulties. However, we have reservations about allowing any credit for passenger cars where there is an element of private use because of the difficulties in administration to which this would give rise. An average deduction such as the 50 per cent proposed by the EEC would solve the administrative problems but would inevitably lead to some inequities.

5.96 Pending further developments in the EEC we are reluctant to make any recommendations for change. A further complication is that Ireland may be precluded from making any changes in the existing arrangements in advance of the implementation of the draft Twelfth Directive. We therefore, recommend that the existing restrictions on the right to deduct input tax be retained, subject to compliance with EEC regulations.

Conclusion

5.97 We conclude that the objective should be to levy a general value-added tax at a single rate. There are clear administrative advantages to be obtained from reducing the number of different rates of value-added tax and by having one rate applied to all goods and services. The proposed new structure would be simpler and more efficient. We believe that an active social policy of granting welfare benefits to people really in need of them would be more effective in achieving redistribution than the use of an indiscriminate instrument like zero-rating. The total system would, therefore, be more equitable. However, policies on housing, transport, sport, energy, industry, education, cultural development and other areas affected by the changes made will have to be examined and changed where necessary. We discuss the transitional arrangements in Chapter 14.

Recommendations

5.98 We make the following recommendations:

1. The general objective should be to levy value-added tax at a single rate on as broad a base as possible. In the context of this general recommendation we make the following additional recommendations:
2. Expenditure on the following items which is zero-rated, or exempt or charged at special rates should be charged fully to VAT:
 - (i) food,
 - (ii) clothing and footwear,
 - (iii) oral medicine,

- (iv) electricity,
 - (v) books,
 - (vi) agricultural services, farm accounting and farm management services,
 - (vii) building and associated services and property transactions already within the scope of VAT subject to a fixed reduction in chargeable value by reference to the unimproved value of sites,
 - (viii) building land subject to a fixed reduction in chargeable value by reference to the unimproved value of land,
 - (ix) passenger transport services,
 - (x) admission to sporting events, and
 - (xi) telecommunications services.
3. Zero-rating or exemption of the following items should be maintained as long as they are compatible with Ireland's obligations to the EEC under the Sixth Directive:
- (i) animal feed stuff, animal oral medicine, fertilisers and seeds (zero-rated),
 - (ii) services supplied by veterinary surgeons (exempt), and
 - (iii) supply of greyhounds and thoroughbred horses (exempt).
4. Expenditure on the following items should continue to be exempt from VAT in accordance with the Sixth Directive:
- (i) education, hospital and medical care,
 - (ii) financial services,
 - (iii) insurance and reinsurance transactions, and
 - (iv) betting (subject to the existing conditions and limitations) and lotteries,
5. Farmers and fishermen should retain the option to register for VAT. Unregistered farmers and fishermen should continue to be compensated for VAT on their purchases by means of a flat-rate addition to the prices at which they sell their produce.
6. The existing restrictions on the right to deduct input tax should be retained subject to compliance with EEC obligations.

Part III

Excise Duties

CHAPTER 6

OVERVIEW OF EXCISE DUTIES

Introduction

6.1 In Chapter 1 we examined the importance of excise duties as a source of revenue in Ireland. Here, we consider some further revenue aspects of excise duties. We also discuss the justification for excises, given that we have recommended a value-added tax on general consumption. We then evaluate excise duties as a form of taxation. A description of the excise system in Ireland and details of the excise receipts for 1982 with an indication of the relative importance of the various duties is in Appendix 11.

System of Excise Duties

6.2 Excise duties are special taxes imposed on certain goods and services. In contrast with sales taxes, which are general in intent, excise duties apply to particular commodities only. The range of goods subject to excises varies even among the member countries of the European Economic Community. Most excise systems apply to traditional excise goods: tobacco products, alcoholic beverages, petroleum products and motor vehicles. In Ireland, betting and a few other commodities are also charged. In some European countries various food products are taxed, as well as some other items of consumption. Historically, excises have been associated with domestically produced commodities; with any corresponding duty on imports being incorporated in the customs duty. In 1975¹ however, fiscal customs duties or the fiscal element of such duties on excisable goods were converted into excises in order to comply with EEC obligations.

6.3 Excises may be levied at specific or *ad valorem* rates. Specific excises are expressed as a fixed amount per excisable unit; *ad valorem* excises are

¹On 16 December, 1975 the Government made an Imposition of Duties Order which was "designed to convert the present fiscal customs duties or the fiscal element of such duties into excises with effect from 1 January, 1976, in accordance with the provisions of Article 38 (3) of the Act attached to the Treaty of Accession to the European Communities. The customs duties in question are those on spirits, beer, wine, tobacco, cider and perry, matches, table waters, oils, motor vehicles (including their parts and accessories) and tyres and tubes".

expressed as a percentage of the value of the unit. Combinations of specific and *ad valorem* rates are sometimes used. The bulk of excise duty revenue in Ireland — about 80 per cent — comes from specific duties, particularly from alcoholic drinks, hydrocarbons and tobacco products.² Excise duty is chargeable on delivery of goods from the premises of a manufacturer, on release from a bonded warehouse, or at point of importation.

6.4 The reality of excise taxes is that they have been imposed on goods either manufactured or imported by a very small number of businesses. The goods themselves have tended to have some characteristic convenient to the assessment of an excise tax; for example, the unit in which they are sold — pint, gallon or pack of twenty, and quality of relevant material — alcohol or leaf tobacco. Furthermore, the goods tended to be widely used.

6.5 The goods, therefore, provided an easy means of raising taxes on a broad base of consumers. For reasons of habit, or way of life, demand did not fluctuate significantly, provided changes in excise duty levels were of a relatively low order. Thus, despite their regressive effects in some cases, excise duties were an accepted means of collecting revenue to finance badly needed public services in the absence of other sales taxes. However, as the relatively new general taxes on consumption — that is to say, value-added taxes — came into being, the question might well have been raised whether these value-added taxes should have substantially subsumed the excise taxes. The arguments in favour of doing this would have been based principally on grounds of equity and economic efficiency. In fact this debate did not occur. As a result, excise duties today form a significant part of the tax base and the revenue receipts in many countries.

6.6 The level of individual excises in EEC countries is affected by the imposition of VAT on the same commodities because VAT is levied not only on the value of the product but also on the excise duty. Thus, the VAT on the excise duty is, in effect, equivalent to an additional excise and not a tax on value added. On this basis the revenues from excise duties are higher than is commonly understood. We examine the impact of VAT on the excise duties on a number of products in Chapter 7. In the remainder of this chapter we discuss excises as they are commonly understood.

Revenue Aspects of Excise Duties

6.7 Valid international comparisons of excise tax burdens are difficult to make because of variations in excise systems. However, an overwhelming proportion of the total yield from excise taxes in EEC countries is derived from six major excises. Table 5 shows the proportion of gross domestic

²Cigarettes are subject to a mixed *ad valorem* and specific structure of excise duty. Other tobacco products are subject to an entirely weight-specific structure of excise duty.

product absorbed by these excises in EEC countries. The share of gross domestic product being taken in the six excises in Ireland in 1981 — the latest year for which comparative figures are available — was over twice the EEC average. By this measure Ireland has the highest excise taxation in the EEC. Leaving aside the duty on wine, the burden of excises in Ireland of individual excises was the highest in the EEC. This confirms the data in Chapter 1 which showed that as a percentage of gross domestic product, Ireland had the highest excises in the OECD.

6.8 Table 6 shows the share of total tax revenue in EEC countries accounted for by the total of the six major excises and by the individual heads of excise duty. This broadly confirms the results derived from Table 5.

TABLE 5
Main Excises in EEC Countries as a Share of Gross Domestic Product 1981

	Ireland's Ranking	Belgium	FR of Germany	Denmark	France	Ireland	Italy	Luxembourg	Netherlands	United Kingdom
Beer	1	0.12	0.08	0.48	0.02	1.83	0.03	0.15	0.07	0.53
Wine	2	0.07	0.04	0.17	0.04	0.19	—	0.09	0.05	0.20
Spirits	1	0.22	0.29	0.38	0.29	1.31	0.10	0.50	0.30	0.48
Tobacco	1	0.60	0.73	1.18	0.29	1.83	0.61	1.23	0.56	1.29
Mineral oils	1	1.17	1.44	1.29	1.51	3.18	1.79	1.89	0.97	1.29
Motor vehicles	1	—	—	0.78	—	1.47	—	—	0.33	0.05
Total of these	1	2.18	2.58	4.28	2.15	9.81	2.53	3.86	2.28	3.84
Excises	1	8	5	2	9	1	6	3	7	4
Country Ranking	1									

Source: Statistical Office of the European Communities and the Department of Finance.

Notes:

- (1) In 1981, the yield from the excises on mineral, oils, tobacco, spirits, wine, beer and motor vehicles accounted in all Member States except Denmark, for an overwhelming proportion of the total yield from excise taxes.
- (2) Motor vehicles are subject to increased value added tax rates in France, Italy and Belgium.

TABLE 6
Main Excises in EEC Countries as a Share of Total Tax Revenue 1981

	Ireland's Ranking	Belgium	FR of Germany	Denmark	France	Ireland	Italy	Luxembourg	Netherlands	United Kingdom
Beer	1	0.40	0.35	1.13	0.08	5.53	0.12	0.47	0.28	1.67
Wine	2	0.24	0.15	0.39	0.15	0.58	—	0.28	0.21	0.63
Spirits	1	0.71	1.20	0.89	1.21	3.97	0.42	1.58	1.14	1.53
Tobacco	1	1.97	3.01	2.74	1.21	5.56	2.68	3.92	2.14	4.07
Mineral oils	1	3.83	5.94	3.01	6.36	9.64	7.90	6.05	3.71	4.07
Motor vehicles	1	—	—	1.82	—	4.46	—	—	1.24	0.16
Total of these	1	7.15	10.65	9.98	9.01	29.74	11.12	12.30	8.74	12.12
Excises	1	9	5	6	7	1	4	2	8	3
Country Ranking	1									

Source: Statistical Office of the European Communities and the Department of Finance.

Note:

Total tax revenue in this instance does not include social security contributions. The data are not, therefore, directly comparable with data in Table 2. Table 3 and Table 4.

6.9 The concentration of the excise system on a small number of goods, yielding a relatively high proportion of total tax revenue, is reflected in the levels of taxation on these commodities. Table 7 shows the excise and total tax content of selected excise goods as a percentage of the retail price. In the case of cigarettes, the excise duty accounts for 57 per cent of the retail price of a pack of twenty, value-added tax accounts for a further 19 per cent. If the total tax on cigarettes, including value-added tax, were levied in the form of a special rate of value-added tax, the rate would be 311 per cent. The corresponding rates of tax on whiskey, beer and petrol would be 94 per cent, 90 per cent and 128 per cent respectively.

TABLE 7
Selected Excise Goods:
Price and Tax Structure as at 29 February, 1984

Item	Retail Price (pence)	Tax Content			
		Excise Duty (pence)	%	VAT %	Total Taxes %
Petrol 1 gallon	289	108	37	19	56
Diesel 1 gallon (for automotive use)	252	78	31	19	50
Whiskey 1 glass	224	67	30	19	49
Brandy 1 glass	286	67	23	19	42
Beer (i.e. ale) 1 pint	116	33	28	19	47
Stout 1 pint	116	36	31	19	50
Wine 75 cl bottle	499	147	29	19	48
Mineral Waters (6 oz bottle)	64	1	2	19	21
Cigarettes 20 pack (standard size tipped)	142	81	57	19	76
Tobacco 25 grammes plug	168	73	43	19	62

Source: Revenue Commissioners and Department of Industry, Trade, Commerce and Tourism, Prices Division.

Notes:

(1) Retail prices represent average prices in each case, except for prices for whiskey, beer and stout which are approved Dublin bar prices. Because of the wide variation in the prices for wines it is not possible to determine a representative price. The 'Retail Price' in the table is included only for the purposes of illustration.

(2) All percentages relate to retail prices.

Justification for Excise Duties

6.10 We consider that excise duties may be justified

- (i) as substitutes for benefit or user charges,
- (ii) to take account of externalities, that is, costs imposed on third parties, or
- (iii) as an economic regulator.

6.11 Excises may act as substitutes for benefit or user charges. For example, motoring taxes may take the place of service charges for the use of the roads. The benefit principle, whereby the beneficiaries of services

provided by government, should pay for them in proportion to their use, is clearly inadvisable as a principle of universal application. However, failure to charge users of certain services with the costs of providing them is likely to have the effect of distorting the use of the nation's resources. It is necessary to take account of the social costs and benefits of a service in determining how much consumers should be charged and how far the cost should be met from general taxation.

6.12 Excises may also be used to improve efficiency in the use of resources. Examples are pollution taxes. Because air and water are treated as free goods, the market system encourages their overuse and, in the process, generates social costs in the form of environmental damage (water and air pollution) which is not accounted for in consumer user charges or product prices. Pollution taxes are designed as charges to the producer or consumer for the external costs associated with the production or consumption of some commodities. However, the use of excises to combat environmental damage is still in its infancy. Regulation is much more common. This may be supplemented by fiscal measures.

6.13 We have considered the use of excises as an economic regulator and as a means of reducing the demand for certain imported goods in order to alleviate balance of payments problems. This is a justification sometimes put forward by government to defend excise duties on items which are not manufactured on a large scale in this country. However, in many cases the balance of payments considerations are overshadowed by revenue considerations and there is often an expectation that demand for the goods will continue, as was the case with the excise duty on video players. When introducing the duty in 1982 the Minister for Finance stated in his budget speech that

"Expenditure on video players has been rising in the past few years and this trend is set to continue. In present circumstances, I consider it appropriate to impose additional taxation on these players, both to reduce the burden on the balance of payments and to add to the exchequer contribution from this highly discretionary expenditure".³

6.14 The balance of payments is a major constraint on faster economic growth in Ireland. In deciding whether to buy Irish made or foreign goods, consumers may fail to take account of the benefits to Irish workers of buying the Irish product. They may also fail to consider the costs arising to society of deflationary policies necessary to correct an excessive balance of payments deficit.

³ Budget Speech, 25 March, 1982.

6.15 The argument is the same as that advanced for protective tariff barriers. Because of Ireland's international treaty obligations the imposition of tariff barriers is not possible. However, it may be possible to introduce what are, in effect, tariffs under the guise of general revenue raisers.

6.16 There is a clear conflict between the two aims of raising revenue and protecting the balance of payments. To take the extreme case; if the tax imposed on a particular category of imports is totally successful in protecting the balance of payments, no goods in that category will be imported and no revenue will be raised. In a situation in which there is such a conflict between policy objectives, it is likely that any policy applied in this area will be very confused.

6.17 The use of excises to reduce imports is a highly selective method of doing so. Excises must be confined to certain types of goods and cannot apply to certain categories of expenditure which may be much more important — for example, expenditure on foreign holidays. We consider that changes in VAT are a better method of demand management, because excises may have disproportionate effects on particular industries. Controls on hire purchase may be a more effective method of reducing import demand, particularly for motor vehicles. However, selective excises are a flexible means of dealing with short-term balance of payments difficulties. As such, they are more suitable than exchange rate changes which are appropriate to deal with long-term structural imbalances.

6.18 We considered the case for higher rates of value-added tax on non-essential or luxury goods in Chapter 5. We concluded that this case was weak. Some may accept that there are strong administrative arguments for a single rate of value-added tax but argue that excises should be imposed on non-essential or luxury items with a view to injecting a degree of progressivity into the system of indirect taxes. This view is based on the argument that there are certain goods and services which are bought mainly by the higher income groups and that such goods should be subject to additional taxation to make the tax system more progressive. We concluded in Chapter 5 that such views are likely to be based on simplistic and erroneous assumptions about the incidence of these taxes.

6.19 Even if luxuries are defined narrowly as being those goods and services which are mainly consumed by the high income groups, it is very difficult to identify such goods for tax purposes. One person's luxury is another's necessity. For example, a car may be less essential in an urban area with a public transport system but absolutely necessary in a remote rural area.

6.20 An alternative method of distinguishing between necessities and luxuries, which avoids subjective notions of what people 'need' or do not

'need', is to regard goods which are highly sensitive to changes in price as luxuries. However, where goods are highly sensitive to price increases, any tax will be shifted to producers to a far greater extent than taxes on goods which are not price sensitive. This defeats the purpose of the tax in the first place. Furthermore, the key to the efficient operation of an excise system is simplicity in administration. Many of the goods which would have to be taxed under a broadly-based excise system on luxuries would not satisfy the criterion for administrative simplicity.

6.21 We consider that progressive taxation of expenditure is best achieved by the direct tax on expenditure proposed in our first report. This would result in greater equity between taxpayers, as individuals within higher income groups may have greatly different tastes for luxury goods, but, on the whole, may spend similar amounts. It would also avoid the problems of identifying the goods to be taxed and be generally more efficient.

6.22 We do not think that excises, that is differential taxes on certain commodities, can be justified solely as a means of raising revenue. The need to raise revenue determines the overall level of taxation. However, it does not, in itself, provide a case for special discriminatory taxes on certain goods. In our view, the excess taxes on these goods must be justified by reference to the criteria we have set out above. Nevertheless, we recognise that excise duties account for a large share of total tax revenue and changes in excise duties which would result in a loss of revenue could only be made in the longer term, as resources permit. The priority is to reduce the level of taxation on those items in which there is substantial diversion of trade to Northern Ireland and Britain due to prices being significantly higher in the Republic.

EVALUATION OF EXCISE DUTIES

6.23 We now evaluate excise duties by reference to our criteria of equity, efficiency and simplicity.

Equity

6.24 The notion of equity requires that persons in the same circumstances should pay the same amount of tax. Those with greater capacity to pay should pay more. Excises discriminate among individuals on the basis of preferences, placing a relatively heavier tax burden on those persons with stronger preferences for the taxed commodities, compared with persons with higher preferences for goods which do not attract duty. Evidence of the effects of excises on the redistribution of income in Ireland is limited. However, on the assumption that excises are shifted to consumers in full the major excises are regressive.

6.25 The assumption that excises are fully passed on to consumers is open to serious question, particularly in the case of goods which are price sensitive. It could be that a higher rate of tax on luxury yachts might have a greater effect on the income of Irish boat builders than in raising money from the rich.

Efficiency

6.26 Where the market produces the best use of resources, the tax system should not distort the way in which consumers spend their money. Special taxes on particular goods can only be justified on efficiency grounds if they are levied in cases in which the market fails to bring about the desired result. This arises where consumers in making choices fail to take account of the costs of their activities on third parties. For example, consumers of paper products do not generally pay for the costs of cleaning up rivers polluted by paper mills. In this case, efficiency would be improved by putting a special tax on paper products related to the cost of pollution. Efficiency is improved if excises are related to specific instances of market failure.

6.27 Excise duties have serious implications for international trade. The border between the Republic of Ireland and Northern Ireland can result in significant shifts in trade if retail prices for similar products are significantly different on each side of the border as a result of excise duty. In addition, these relative excise duties have serious implications for tourism. It is very important to recognise that the tourist is mainly concerned with the cost of hotel and restaurant services, drink, tobacco and petrol. Where any of these is unduly high by international standards, it discourages tourism.

Simplicity

6.28 Excise duties are extremely simple to collect. Very few enterprises have the legal responsibility for payment and these will already have the machinery for calculating the liability as part of their normal activities.

6.29 The fact that excises are collected at a limited number of points of charge facilitates tight control by the Revenue Commissioners. The possibilities of evasion in the case of domestically produced goods are very limited. A more serious problem arises in controlling smuggling. Very high rates of duty on certain items may result in significant price differentials arising between goods in different fiscal jurisdictions. In Ireland, the movement of goods across the border with Northern Ireland is impossible to control absolutely. The potential for avoidance and evasion of duty is great when significant price differences emerge between Northern Ireland and the Republic.

6.30 Imports must also be cleared by customs and excise officers. Delays at ports or other points of entry may impose heavy compliance costs on business. It is important to ensure that the procedures adopted by the Revenue Commissioners in such instances impose the minimum possible costs on business consistent with maintaining reasonable security of the revenue.

International Constraints

6.31 Abolition of tax frontiers has been an objective of the EEC since its inception. This objective cannot be attained until VAT and excise duty rates are harmonised.⁴ In 1972, the EEC Commission issued a framework directive which proposed a programme for harmonising tax systems. The programme incorporates arrangements to harmonise excise structures and proposes to prevent member states from introducing any new excises necessitating compensation arrangements or checks at frontiers. The Commission classified the existing excises in the member states into four main groups:

- (i) harmonised excises to be levied in all member states on tobacco products, alcoholic beverages, and petroleum products; agreement on common definitions for the various bases of assessment should be followed by rate unification,
- (ii) excises, e.g. on matches, playing cards, and gramophone records, to be incorporated in increased value-added tax rates, and thereby eliminated,
- (iii) excises, e.g. on entertainment and betting, that might be retained, because they do not involve tax adjustments or affect trade between member states, and
- (iv) excises to be abolished, because their contribution to revenue is negligible, because they are levied on products imported from developing countries (e.g. coffee), or because they are in larger part a raw material for industry (e.g. sugar).

6.32 The results so far in this field are limited. Further progress towards harmonisation is likely to be extremely slow. Harmonisation of excise duties on cigarettes is the only directive which has been agreed and implemented in part. The community system chosen for cigarettes is partly specific and partly *ad valorem*. This system is in large measure a compromise

⁴ A paper by Sijbren Cnossen argues that border controls can be fully eliminated by shifting border tax adjustments for value-added taxes to books of account and for excises to factory gates and retail outlets. For the excises it would be essential to have uniform bases of assessment; a uniform system of in-bond transportation of excisable goods would also have to be devised. *Harmonisation of Indirect Taxes in the EEC*. British Tax Review, 1983 November 4 pps 232-253.

between the two extremes of wholly specific and wholly *ad valorem* systems which applied in the original six member states. At present the specific element may vary between 5 per cent and 55 per cent of the total tax burden (including VAT) levied on the most popular price category. Proposals at present before the Council, if adopted, would see a further narrowing of the gap between minimum and maximum specific rates so that by 1986 the specific component would fall between 10 per cent and 35 per cent of the total tax burden. At the final stage, a single ratio must be fixed for the specific element.

6.33 Progress in harmonising the cigarette excise has been slow and difficult, mainly because the cigarette markets of the member states differ in many important respects. The Irish tobacco industry is strongly opposed to the adoption of any further harmonisation measures which would increase the proportional tax element in the retail price of Irish cigarettes. They argue that high rates of proportional taxation distort competition by multiplying small differences in pre-tax manufacturer's selling prices into large differences in retail prices. Accordingly, a tax structure with a high *ad valorem* content gives cheaper, low quality cigarettes a competitive advantage over high quality brands in terms of final price. Since, for historical reasons, Irish cigarettes are made from high-cost, high quality tobacco and packaged to a high standard, compared with continental cigarettes, a high proportionate tax would make Irish cigarettes less competitive and open the Irish market to cheap foreign cigarettes, while Irish manufacturers would be virtually precluded from competing in EEC export markets. Such a development, the industry claims, would lead to the decline and ultimate demise of Irish tobacco manufacturing. The Joint Committee on the Secondary Legislation of the European Communities⁵ which considered EEC proposals for changes in the taxation of manufactured tobacco was "convinced of the validity of the general case put forward by the Irish Tobacco Manufacturers".

6.34 The Council has not yet acted on the other proposals before it for the harmonisation of excises on alcoholic beverages and mineral oils. In contrast to the situation with regard to tobacco these products are subject to totally specific taxes throughout the Community.⁶ No proposals have been put forward for a change to an *ad valorem* type of duty or tax. The proposed directives are mainly concerned with eliminating the distorting effects of tax structures on competition.

⁵ *Taxes other than Turnover Taxes which affect the Consumption of Manufactured Tobacco*, Joint Committee on the Secondary Legislation of the European Communities — 87th Report, March, 1981, Prl. 9679.

⁶ Denmark now applies a mixed specific and *ad valorem* structure of excise duty on spirits. A previous two-tier specific excise duty structure was condemned by the Court of Justice because of the protective effect for *aquavit*. The Commission has not so far taken any further action.

6.35 In addition to the constraints imposed by Community harmonisation in matters of indirect taxation, Article 95 of the Treaty of Rome imposes significant constraints on national sovereignty in the matter of discrimination in internal taxation. Article 95 complements and reinforces the prohibition on customs duties, quantitative restrictions and measures of equivalent effect in intra-community trade by forbidding the use of taxation as a form of non-tariff barrier. The only purpose of Article 95 is to guarantee the neutrality of internal taxes with regard to cross-border movement of goods. Article 95 relates to discrimination against imports from other member states; it does not relate to distortion of competition. Member states are not restricted by the Treaty as regards their powers to levy taxes or to introduce new taxes provided, however, that they respect the prohibition on discrimination which is guaranteed by Article 95. The article is directly applicable to all member states and has force of law independently of any other Community measures for harmonisation of tax systems.

Conclusion

6.36 Excise duties are among the oldest taxes in Ireland. They are high by international standards. Because VAT is applied both to the excise duty and the normal concept of value added, excises are, in effect, even higher than their nominal value would suggest. They are discriminatory taxes but are relatively simple to collect. They may also increase efficiency in the use of resources where market prices do not reflect all of the costs involved. Changes in excises may also be used as a short-term economic regulator. However, changes in VAT may be more appropriate as an instrument of demand management, while hire purchase controls may be used to reduce demand for particular categories of imports. In setting the level of excise duties, account must be taken of the effects on tourism and other industries if prices in the Republic are higher than in other jurisdictions, particularly Northern Ireland.

CHAPTER 7

STRUCTURAL ASPECTS OF EXCISE DUTIES

Introduction

7.1 In this chapter we consider whether excise duties should be at specific or *ad valorem* rates. We also examine the adjustment of specific duties to take account of inflation.

Specific Versus Ad Valorem Rates

7.2 Most excise duties in Ireland are specific. Specific rates are clearly easier to apply than *ad valorem* rates, because the value of the excisable goods does not have to be ascertained and undervaluation cannot occur, thereby greatly reducing the scope for evasion. This is particularly important in the case of cigarettes and petrol which are taxed at rates that amount to a multiple of pre-tax values. While the specific rate system has been used mainly on the grounds of administrative convenience, there are other reasons why specific rates are to be preferred to *ad valorem* rates. These relate to the differences between the effects of the two types of excises.

7.3 We consider that excise duties must be justified on efficiency grounds. It is important that the tax structure should be designed to achieve the intended purpose of a duty. Where the aim is to charge the consumer with the external costs of consumption of a particular commodity this may best be achieved by a specific rate of duty, since the costs imposed by these products relate to the quantity used rather than their value. Thus, for example, a specific excise on petrol related to the lead content would be more efficient as a means of charging the consumer with the costs of lead pollution than an *ad valorem* tax on petrol related only to the pre-tax value. The same would be true of a specific excise on alcoholic beverages related to the alcohol content, or a specific excise on cigarettes related to the tar and nicotine content.

7.4 From the point of view of adjusting excise duties to take account of inflation it might be argued that there would be administrative advantages in shifting to an *ad valorem* tax, a change that is already partially underway

due to EEC regulations in the case of cigarettes. We do not favour this approach.

7.5 In general, the value before tax of excisable goods is relatively low in comparison with the duties imposed on them. To maintain the present level of tax yield it would, in each case, be necessary to impose *ad valorem* duties at such a high rate that minor variations in the pre-tax price would produce disproportionate effects on retail selling prices. This would reduce the competitiveness of high quality, high cost goods vis-à-vis low quality, low cost goods. This in turn would result in price competition by the industries concerned at the expense of the Exchequer because the cost to the manufacturer of any reduction in retail prices would be much less than the cost to the Exchequer where *ad valorem* taxes comprised a high proportion of the retail price. Unless applied at the retail level (which would seriously weaken the control of the system by the Revenue Commissioners), there would be problems in identifying the value of the commodity for excise duty purposes. There could also be price manipulation between different stages of production and distribution leading to tax evasion. Finally, a shift to *ad valorem* excises would not accord with present EEC proposals on excise duty harmonisation, which envisage the continuation of specific duties (except for cigarettes where a part specific/part *ad valorem* excise will be applied).

Adjustment of Specific Excises for Inflation

7.6 During inflationary periods, adjustments required purely to maintain the real value of specific duties appear as increases and as such encounter some resistance. Table 8 shows increases in rates of excise duty on selected commodities since 1973 compared with the increase in the consumer price index.

7.7 Table 8 shows that excise duty rates have changed frequently for the four products since 1973. Over the period as a whole the excises in question, with the exception of the duty on spirits, have increased slightly in real terms. However, two distinct periods emerge from the data. Up to 1980 the excises declined sharply in real terms. The duties on petrol and beer increased in real terms in the mid-seventies but by 1980 their real values had declined. Since 1980, excise duties have increased sharply in real terms. The result is that at January, 1984 the duties on beer, petrol and cigarettes had increased in real terms since January, 1973.

7.8 In addition to excise duty, all excise goods bear VAT at the low rate. The amount on which VAT is chargeable includes the excise duty on the product. It could be argued, therefore, that the VAT on the excise duty should be regarded as an excise duty and not a tax on value-added. When VAT was introduced the low rate was 5.26 per cent. This rate increased to

6.75 per cent and later to 10 per cent in 1979. Since 1980 the low rate of VAT has increased on three occasions and now stands at 23 per cent.

TABLE 8

Indices of the Changes in Excise Duties on Spirits, Beer, Petrol and Cigarettes 1973-84

January	1 Glass of Whiskey or Brandy	1 Pint of Beer	1 Gallon of Petrol	20 Cigarettes (standard-size tipped) ³	Consumer Price Index ¹
1973	100	100	100	100	100
1974	<u>114</u> ²	105	100	111	114
1975	114	105	<u>162</u>	110	130
1976	142	143	<u>164</u>	135	152
1977	170	<u>207</u>	<u>209</u>	150	183
1978	170	<u>207</u>	<u>209</u>	155	203
1979	170	207	209	157	219
1980	202	226	209	198	264
1981	289	<u>300</u>	296	269	300
1982	365	<u>398</u>	378	363	379
1983	395	<u>445</u>	413	<u>436</u>	416
1984	399	<u>464</u>	<u>496</u>	<u>496</u>	459

Source: Revenue Commissioners and the Central Statistics Office.

Notes

(1) The consumer price index figure in each case is the figure for mid-November of the previous year, except for 1973, 1974, 1980 and 1982 where the figures for mid-February of the year concerned is given. The mid-February figures related to years when budget day was later than mid-February.

(2) Those instances in which the increase in rates since 1973 has matched or exceeded the increase in the consumer price index are underlined.

(3) Cigarettes:

Three brands [i.e. Carrolls Number 1, Silk Cut (Gallaghers) and Gold Leaf (Player Wills)] make up the standard-size tipped sector of the market throughout the period 1973-84. The maximum retail price at 1 January of each year was the same for all three brands, except at 1 January, 1983 when the retail price of Carrolls Number 1 was 2p/20 higher than the retail price of the other two brands.

During the period 1973-1977, the excise duty burden depended on tobacco weight specifications. The excise duty burden for each of the three brands at 1 January of each year was estimated on the basis of average weights.

Whenever at 1 January there was a difference in the excise duty burden and in the total tax burden on the three separate brands, the index data are based on a weighted average burden by reference to the relative volume of sales of each of the three brands during the year following each 1 January in question. This weighting procedure was therefore applied to the years 1973 to 1977 and to 1983.

7.9 Table 9 shows the changes in excise duty, as increased by the VAT on the excise duty, on selected excise commodities since 1973. In the period 1973 to 1980 the combined effects of excise increases and changes in VAT were insufficient to maintain the real incidence of taxation on spirits and

cigarettes; in the latter case taxes increased by 106 per cent whilst the consumer price index rose by 164 per cent. Since that time increases in combined taxes on cigarettes and on petrol have been more than twice the amount necessary to maintain the real incidence; increases in combined

TABLE 9

Indices of the Changes in the Total of Excise Duty and VAT on the Excise Duty: Spirits, Beer, Petrol and Cigarettes 1973-84

January	1 Glass of Whiskey or Brandy	1 Pint of Beer	1 Gallon of Petrol	20 Cigarettes (standard-size tipped)	Consumer Price Index
1973	100	100	100	100	100
1974	<u>116</u>	106	101	112	114
1975	116	106	<u>166</u>	112	130
1976	144	145	<u>166</u>	136	152
1977	177	<u>215</u>	<u>218</u>	157	183
1978	177	<u>215</u>	<u>218</u>	162	203
1979	177	215	218	164	219
1980	211	236	218	206	264
1981	<u>302</u>	<u>313</u>	<u>310</u>	281	300
1982	<u>398</u>	<u>435</u>	<u>413</u>	<u>395</u>	379
1983	<u>443</u>	<u>499</u>	<u>462</u>	<u>487</u>	416
1984	<u>466</u>	<u>542</u>	<u>580</u>	<u>577</u>	459
Percentage increase since 1980	121	130	166	180	73

Source: Revenue Commissioners and the Central Statistics Office.

Notes

(1) The consumer price index figure in each case is the figure for mid-November of the previous year, except for 1973, 1974, 1980 and 1982 where the figures for mid-February of the year concerned is given. The mid-February figures related to years when budget day was later than mid-February.

(2) Those instances in which the increase in rates since 1973 has matched or exceeded the increase in the consumer price index are underlined.

(3) Cigarettes:

Three brands (i.e. Carrolls Number 1, Silk Cut (Gallaghers) and Gold Leaf (Player Wills)) make up the standard-size tipped sector of the market throughout the period 1973-84.

The maximum retail price at 1 January of each year was the same for all three brands, except at 1 January, 1983 when the retail price of Carrolls Number 1 was 2p/20 higher than the retail price of the other two brands.

During the period 1973-1977, the excise duty burden depended on tobacco weight specifications. The excise duty burden for each of the three brands at 1 January of each year was estimated on the basis of average weights.

Whenever at 1 January there was a difference in the excise duty burden and in the total tax burden on the three separate brands, the index data are based on a weighted average burden by reference to the relative volume of sales of each of the three brands during the year following each 1 January in question. This weighting procedure was therefore applied to the years 1973 to 1977 and to 1983.

taxes on the other products have been more than one and a half times the amount necessary to maintain the real incidence. The result is that at January, 1984 the excise duties on beer, petrol and cigarettes as increased by the VAT on the excise duties had increased substantially in real terms since January, 1973.

7.10 The uneven and seemingly arbitrary approach to changing excise rates in the past decade has been one of the factors contributing to the distortions in the distribution of the tax burden between one period and the next. It has also had implications for the industries concerned. Up to the end of the 1970s changes in excise duties tended to be small on each occasion, resulting in many cases in declining real incidence. During this period VAT rates were relatively low and VAT did not significantly increase the total excise burden. The experience since 1980 has been quite different. Changes in excises have been large and the total excise burden has been increased further by increases in VAT rates. Changes of tax policy of the magnitude witnessed in recent years, at a time when real disposable incomes have been falling, have serious consequences for real demand in the excise industries and therefore for investment and employment.

7.11 We consider that a systematic approach to changes in excise taxes is necessary. The unpredictability of changes in recent years has caused uncertainty and has precluded any effective planning within the excise duty industries. Increases in excise duties brought about by changes in VAT rates should be taken into account in any decision to maintain the real value of excises or to increase them in real terms.

7.12 We recommended in our first report that the tax system be neutral with respect to inflation. If specific rates of duty are to be used, it is essential that these duties be adjusted automatically in line with inflation. Any adjustment of specific duties to take account of inflation raises two questions. The first concerns the choice of index. We favour the consumer price index for the reasons set out in Chapter 20 of our first report.

7.13 The second question relates to the timing of adjustments. On the grounds of simplicity, an annual adjustment of specific excise duties might seem most appropriate. However, at relatively high rates of inflation, the increases would be such as to cause distortions of trade by encouraging traders to remove additional amounts from bond before the increase with a view to selling them later at the higher price. While this 'forestalling', as it is called, takes place under the present arrangements, it is lessened by the uncertainty (illustrated in Table 9) about whether there will be an increase and the amount of such an increase and by the fact that the Revenue Commissioners use their power to limit the amounts of dutiable goods withdrawn from bond. Adjustments on a quarterly basis would minimise this problem, since the adjustments would be relatively small.

7.14 The Department of Finance and the Revenue Commissioners advised us that

"Alterations in excise duty rates involve widespread changes of an administrative and accounting nature both for the Revenue Commissioners and for the particular traders concerned. For this reason, adjustments on a quarterly basis would not be recommended. For the main specific excise duties, viz alcoholic beverages, hydrocarbons and tobacco, an annual adjustment would seem appropriate. In view of the administrative considerations and having regard to the relatively insignificant yield from the minor excise duties, viz table waters, TVs, videos, matches, lighters and licences, these duties should perhaps be adjusted on a less regular basis."¹

We pressed the Revenue Commissioners on this point and they informed us that while their "preference would be for changes on an annual basis rather than at more frequent intervals" they "would be able to cope with indexation even if this were done quarterly."² It should be noted that we recommend the elimination of many minor excise duties such as those on table waters, matches and mechanical lighters. We consider that an adjustment should only be made when the increase in the consumer price index since the previous adjustment reaches a minimum level. We do not think that adjustments should be made more frequently than quarterly.

7.15 In summary, we believe that excise duties should be wholly specific. We recommend, however, that specific excises should be adjusted automatically to take account of the effects of inflation; the adjustment should be made by reference to the increase in the consumer price index when the increase in the index since the previous adjustment reaches a particular threshold. When inflation does not reach the threshold in any quarter the adjustment should be carried over into the next period. Increases in excise duties brought about by changes in VAT rates should be taken into account in any decision to maintain the real value of excises or to increase them in real terms. Inflation adjustment of specific excises does not involve maintaining a fixed incidence of taxation on retail prices. Government would retain the right to make discretionary adjustments to excise duties but these should be made explicitly by reference to the indexed position.

Recommendations

7.16 We make the following recommendations:

1. Excise duties should be levied at wholly specific rates, subject to compliance with EEC directives in the case of cigarettes.

¹Letter of 12 May, 1982.

²Discussion with the Revenue Commissioners, Dublin Castle, 13 July, 1983.

2. Specific excises should be adjusted automatically on a quarterly basis to take account of the effects of inflation. The adjustment should be made by reference to the increase in the consumer price index in the preceding quarter. When inflation does not reach a minimum level in any quarter, the adjustment should be deferred until the next period.

CHAPTER 8

EXCISES ON ALCOHOLIC BEVERAGES

Introduction

8.1 In the next few chapters we evaluate the existing excises in terms of the criteria set down in Chapter 6. We have grouped the excises into five main classes.

- (i) Alcohol (including beer, spirits, wine, cider and perry) and table waters.
- (ii) Tobacco (including cigarettes, cigars and other tobacco products) (Chapter 9).
- (iii) Motor vehicles, motor vehicle parts and accessories (including tyres) and hydrocarbon oils (Chapter 10).
- (iv) Betting duties and gaming machine licences (Chapter 11).
- (v) Miscellaneous excises (Chapter 12).

The discussion in this chapter relates to excise duties on alcoholic beverages. We consider the justification for such duties, review their present structures and make recommendations for change.

Present System

8.2 The excise duties on alcoholic beverages are charged on four main categories of beverages: beer, cider and perry, spirits, and wine. However, there are many different classes of drinks within these categories and goods containing spirits are also subject to excise duty. The basis of assessment varies for each category and the rate of duty varies for each class. For example, the duty on beer is calculated at the worts, i.e. pre-fermentation stage of manufacture, whereas the duty on spirits is calculated on the final product and the rate varies depending on how long the spirits have been warehoused. However, all of the duties imposed on alcoholic beverages are specific excises. Finally, there are a number of favourable rates for goods

used for special purposes or produced by particular types of manufacturers. Full details of the excise duties on alcoholic beverages together with details of the various reliefs available are in Appendix 12.

CASE FOR EXCISE DUTIES ON ALCOHOL

8.3 The use of alcohol is beneficial in certain circumstances. However, its abuse does cause major social problems. Abuse of alcohol is a major cause of mental illness, of disrupted families, of fatal or disabling road accidents and of inefficiency at work. It also contributes to a wide range of physical illnesses. Burdens are put on health and social services for which all pay, as well as on commerce and industry. Excise duties on alcohol may therefore be justified by the need to offset the costs which are imposed on the community by the effects of alcohol abuse. Appendix 13 examines the evidence in relation to these costs.

Equity

8.4 Excise taxes on alcohol over and above the normal tax rate applied to other goods would be fair where they simply charge drinkers for the full costs of drinking. However, alcohol taxation as a revenue source discriminates between people with similar incomes and different tastes. Evidence from household budget surveys with regard to expenditure on alcohol is unreliable. However, on the assumption that the degree of understatement of this expenditure is the same for all income groups, taxation of alcohol is likely to be regressive.

Efficiency

8.5 Taxation of alcohol should offset the costs which are imposed on the community by the consumption of alcohol. Selective taxes on alcoholic beverages would increase efficiency if they charged the consumer for the social costs associated with consumption. Unfortunately, a tax related to the marginal external costs per unit of alcohol is impossible because marginal external costs associated with consumption of each unit cannot be determined in advance. These costs depend on whether the consumer is a heavy or moderate user, under what circumstances he uses alcohol (e.g. before, during or after a meal) and where he does so (e.g. in a pub or at home). Apart from the fact that the information on the marginal external cost for each circumstance simply does not exist, it would be administratively impossible to impose tax on this basis, even if the information were available.

8.6 The only practicable solution is an insurance approach to taxing external costs of alcohol consumption. The principle here is analogous, for example, to compulsory third party motor insurance: alcohol consumers

as a group should meet all the costs of alcohol consumption. Insurance in this context is used in the sense that the tax on drink can be regarded as a premium, which increases as the individual's consumption increases. These payments are justified on grounds of efficiency, up to the point where they cover the costs to the community of alcohol consumption.

8.7 There are significant external costs associated with alcohol abuse. These costs arise in various ways but four types of loss predominate. These are

- (i) the loss in total production due to alcohol-related incapacity, absenteeism and deaths,
- (ii) the commitment of resources in the health care sector to the treatment of patients with alcohol-related problems,
- (iii) the various real losses to society from traffic accidents, fires and criminal acts in which alcohol is a factor, and
- (iv) the expenditure of resources by society to deal with the problems and effects of alcohol abuse.

8.8 Alcohol abuse is a major cause of absenteeism. It seems likely that the largest economic cost associated with alcohol abuse is the lost production from diminished and inefficient participation at work. Productivity losses may be borne, in part, in the form of income losses to others, that is, shifted to owners and fellow workers, or the community at large, as well as the alcohol consumer and his family.

8.9 Alcohol is the third highest killer after heart disease and cancer. Alcohol can also be a causative or complicating factor in many illnesses for which specialist treatment is required as well as in many minor ailments treated by general practitioners (this is significant with a fee per item such as exists in Ireland). In 1980, there were 7,021 admissions to psychiatric hospitals for the treatment of alcoholism. In the same year 1,704 people attended one out-patient clinic in Dublin.

8.10 The most widely recognised cost of alcohol abuse is the part alcohol plays in road traffic accidents. In a survey of fatalities by consultant pathologists in Ireland, 40 per cent of drivers killed in road traffic accidents had a blood alcohol level in excess of 125 mgs/100 mls.¹ One in three pedestrians in the sample had a blood alcohol level in excess of 200 mgs/100 mls. Some efforts are made in court cases to quantify the costs of accidents. In the young quadriplegic or severe brain injury case, a settlement of £300,000 is common and the insurance company is often happy to settle for

¹ The legal limit of blood alcohol level for a person in charge of a vehicle is 100 mgs/100 mls.

£250,000. Minor fractures may involve thousands of pounds in compensation. These costs are in addition to the administrative and other costs.

8.11 The costs of programmes such as those carried out by the Health Education Bureau or the campaign against drinking and driving sponsored by the National Road Safety Association must also be included in the estimate of the total costs to society of alcohol abuse.

8.12 Only one attempt² has been made to estimate the costs imposed by alcohol consumption in Ireland. This study, in the words of the author, "advocates a fairly narrow idea of 'costs' in this context". The estimate for 1976 indicated that the cost of alcohol consumption borne by the state in that year was £63 million, whereas excise duties on alcohol amounted to £158 million. Further details of the costs of alcohol abuse are in Appendix 13.

8.13 While there are significant external costs associated with alcohol abuse some of these costs may be offset by the contribution to the economy arising from the manufacture and sale of alcohol in Ireland. The importance of the drinks industry (i.e. including the production of aerated and mineral waters) in relation to employment and the balance of payments may be summarised as follows:

- (i) in 1981, a total of 38,000, or 3.2 per cent of the labour force, was in full-time employment connected with the drinks industry, with a further 13,000 in part-time employment,
- (ii) exports of alcoholic beverages were almost three times the value of imports of alcoholic beverages in 1981. (Figures supplied by the Drinks Industry Group suggest that the ratio of exports to imports was as high as 4.0 for 1982),
- (iii) the import content of the inputs used by the drinks industry is markedly lower than in all other major sectors of manufacturing industry. The balance of payments effect of exporting a given value of output is notably greater for the drinks industry than for virtually all other major sectors of Irish manufacturing industry,
- (iv) the drinks industry is an important asset to Irish tourism: 32 per cent of all overseas visitors to Ireland in 1979 visited 'singing' pubs; 51 per cent of Irish people on short holidays in Ireland also engaged in this pastime; certain products such as stout, Irish whiskey, cream liqueurs are significant in international perceptions of Ireland, and,

² B. M. Walsh, *Drinking in Ireland*, ESRI, 1980. (See Appendix 13).

as such, promotional campaigns abroad for these products may indirectly promote Ireland as a tourist destination.³

8.14 In assessing the economic importance of the alcoholic beverage industry to the economy, what matters is not so much how many people or other resources are currently dependent on the industry for employment, but rather how specific to the industry these resources are. While it is obvious that much of the labour force, plant and equipment, and other resources currently dependent on the industry in Ireland are fairly specific to the industry and would only be redeployed in other sectors at a considerable cost, it is also true that, unlike the wine-producing regions of Europe, Ireland does not have a high regional dependence on producing alcohol from crops grown on land which would have very low productivity in alternative uses. However, the endemic high unemployment rate in Ireland lends force to the argument that it would be difficult to replace the jobs lost in any major contraction of the alcohol trade.⁴

Taxation of Alcohol in Other Countries

8.15 We believe that some regard must be had to the level of taxation of alcohol which prevails in other countries, particularly the United Kingdom. There is, however, no consistent level of taxation on alcohol among EEC countries. The data in Table 10 indicate that the relative level of tax per litre of pure alcohol consumed in 1980 ranged from 161 in Ireland to 100 in the United Kingdom to 4 in Italy. This wide variation in the level of special taxes on alcohol is likely to delay considerably progress towards eventual harmonisation of tax rates as proposed by the EEC Commission.

TABLE 10
Special Taxes on a Litre of Alcohol,* 1980: UK = 100

Ireland	161	W. Germany	24
Spain	22	Netherlands	41
France	20	Denmark	109
Belgium	32	United Kingdom	100
		Italy	4

Source: John W. O'Hagan, *The Rationale for Special Taxes on Alcohol: A Critique*, British Tax Review, 1983 No. 6, pps. 370-380.

Note:

*These figures are intended only to indicate the broad range of duties applied: the comparisons at any point in time are clearly influenced by the exchange rates in operation and other variable factors. They are compiled from data in M. Brown and P. Wallace, *Alcoholic Beverage Taxation and Control Policies (4th ed.) (1980)*, with the rates given for beer, spirits, and wine weighted according to consumption to give a single aggregate rate.

³ A. A. John and J. W. O'Hagan, *The Economic Importance of the Drinks Industry in Ireland*, 1982. Full details of this study are reproduced in Appendix 14.

⁴ D. Walsh and B. Walsh 'Drowning the Shamrock: Alcohol and Drink in Ireland in the Post War Period', in E. Smyle, P. Morgan and J. de Lint (editors), *Alcohol, Society and the State*, Vol. 2, Addiction and Research Foundation, Toronto, 1981, p. 108.

8.16 The Drinks Industry Group advised us that:

"Taxation increases have created a differential between retail prices in the North and the South. This has given rise to smuggling on a large scale and the transfer of business across the border. The distillers estimate that 150,000 cases of spirits have been smuggled across the border this year⁵. In addition, people in border areas are going into the North to hold wedding receptions and other functions."

8.17 Whiskey exports to Northern Ireland in the year to August, 1983 were almost 300 per cent higher than in the year to August, 1979. As exports of whiskey to Britain rose by only 23 per cent in the same period, Dowling⁶ has argued that it is reasonable to assume that over half of the sales to Northern Ireland are for re-export to the Republic. He has estimated that the excise duty and VAT foregone on such a trade would amount to £61 million.

8.18 High excise duties on alcohol in Ireland are the most important factor in the differential between retail prices in Northern Ireland and the Republic. A closer alignment of excise duty rates would reduce the incentive for avoidance and evasion of duty.

Conclusions

8.19 In principle, we believe that excise duties on alcohol may be justified on the grounds that there are significant external costs associated with alcohol consumption. We have identified the main areas where costs and benefits arise but it is extremely difficult to quantify the net social costs in economic terms. A further complication is that high levels of tax on alcohol can provide an incentive for the illegal production and sale of alcoholic drink and for smuggling, if they bring substantial price differences between neighbouring countries. In these circumstances, we consider that the immediate objective should be to ensure that the combined incidence of excise duties and VAT on alcohol should not be so high as to result in higher retail prices in Ireland than in neighbouring jurisdictions after adjustment for exchange rate differences. This only encourages cross-border smuggling and the illegal production and sale of alcoholic drink on a large scale. In the longer term, it may be necessary to align the incidence of excise duties more closely with the other member states of the EEC. We

⁵ 1983.

⁶ Irish Times, 16 January, 1984.

recommend that, in determining the excise duty on alcohol, account should be taken of the need to avoid the price of alcohol in the Republic becoming significantly higher than in Northern Ireland.

RATE DIFFERENTIATION

8.20 Having drawn these broad conclusions we now turn to the differentiation of rates of any excise duties on various forms of alcohol. Excise duties on alcohol should bear some relation to the net external costs imposed on society by the consumption of alcohol. There is, however, no conclusive evidence that one form of alcohol is more harmful than another or that one type of alcoholic drink should be encouraged at the expense of another because it is less likely to lead to abuse. Nevertheless, some would argue the stronger the drink the more dangerous, at least for young drinkers. We consider that it is the function of health education programmes to ensure that drinkers have full knowledge of the consequences of drinking. Regulatory measures, such as drinking laws and controls on advertising, may be used to complement or support health education programmes. We consider, therefore, that excise tax on beer, spirits and wine should be related to the alcohol content of these beverages. Ideally, the rate of tax per litre of pure alcohol should be at the same level whatever the beverage. This is not the case at present as illustrated by Table 11.

8.21 The Revenue Commissioners informed us that on the basis of a single rate of duty per litre of alcohol the rate of duty in present terms would be approximately £18.10 per litre of alcohol. The estimated effect,⁷ including consequential VAT changes, on the prices of the beverages concerned is as follows:

Pint of beer — increase of 5p
Half glass of spirits — reduction of 12p
Bottle of table wine — increase of 4p
Litre of cider — increase of 91p
Litre of champagne — reduction of £1.94

8.22 There are some administrative difficulties involved in charging all alcoholic drinks on the basis of a single rate of duty per litre of alcohol. The duty on beer is charged during the brewing process and it is not possible at that stage to determine what the eventual alcoholic strength of the beverages

⁷ The single rate per litre of alcohol was calculated by reference to current excise rates and consumption patterns and the estimated average alcoholic strengths for the various commodities concerned (the strength of which may vary considerably).

to be put on sale from that brew will be. At a technical level, therefore, a charge related to the alcoholic strength of beer would be feasible only if the duty were charged on an end product basis. This issue is discussed later but, in principle, we favour a change to an end product duty in the long term.

TABLE 11
Comparison of Excise Duty on various Alcoholic Drinks, March, 1984

Beverage	Duty per Litre of Alcohol
	IRE
Beer	16.658
Spirits	23.420
Wine	17.818
at 11%	13.067
at 15%	15.778
at 18%	16.864
at 22%	30.231
Sparkling at 13%	
Cider/Perry	2.915
at 6%	6.574
at 8.7%	17.000
at 10%	

Source: Revenue Commissioners.

Notes:

- (1) The figures for beer are based on the average strength of all beers consumed in Ireland. Ale would be lower than the average, lager slightly higher, with stout close to the average.
- (2) The figure quoted for spirits is that for whiskey — the most popular spirit. The same rate applies to brandy. The figure for gin and vodka is £23.468.
- (3) Wine does *not* include 'made wine' which is made from ingredients other than fresh grapes. The duty levels are somewhat lower.
- (4) The vast bulk of cider and perry is in the lowest strength band and the normal alcoholic strength is around 4 per cent.

8.23 The Revenue Commissioners advised us that "because there is such a wide variety of alcoholic drinks, especially imported wines, it would be much more costly to implement a duty structure based on alcoholic strength". However, in applying the principle that the tax on alcoholic drinks should be related to the alcohol content, we do not envisage a change in the present method of charging duty on wines and cider and perry by reference to a system of graduated bands of alcoholic strength to overcome the problem of testing each consignment for alcohol strength.

8.24. There may be some inconsistency between on the one hand ensuring that the level of excise on the various alcoholic drinks is not so high as to encourage cross-border smuggling and on the other hand levying the excise at a single rate on a unit of alcohol, irrespective of the form in which it is consumed. However, cross-border smuggling of alcohol is concerned

mainly with spirits and a change to a single rate of duty per litre of alcohol would result in a reduction in the tax on spirits. This would reduce the incentive for smuggling.

8.25 The EEC proposals on harmonisation of excise duties, while dormant at present, must be taken into consideration in any examination of the duty structures for alcoholic beverages. These proposals envisage a certain relationship between the taxation of beer and wine and between the rates on spirits and products such as liqueur wines; it is also proposed that beer and wine should be taxed on a volume basis but that spirits and liqueur wines should be taxed on alcoholic strength and that spirits should bear a higher duty than liqueur wines and the like.

8.26 The feasibility of introducing a harmonised EEC system involving a single rate of excise duty per degree of alcohol for all alcoholic beverages was examined in a report prepared last year for the Economic and Monetary Affairs Committee of the European Parliament. The report acknowledged, however, that there were obstacles of a political, fiscal and commercial nature and it came down in favour of achieving, on a phased basis, a system of three groupings in which there would be a general relationship between the burden of taxation on all forms of alcoholic beverages; the first two groupings (which include beer and wine) being charged on a volume basis and the third group (covering drinks with an alcoholic strength exceeding 15 per cent alcohol by volume) being taxed per degree of alcohol. If it is not possible to harmonise the bases of assessment along those lines at the conference table, it seems likely that it will be achieved through the judicial process. In proceedings against the United Kingdom, the EEC Commission argued successfully that the British excise on light wines made from grapes, which was five times higher than the beer excise, should be reduced, or the latter increased, so as to establish an appropriate relationship based on the alcoholic strength of the respective beverages. Proceedings have been initiated along similar lines in two further cases.

8.27 We recommend that the excise tax on beer, spirits, wine and other alcoholic drinks should be related to the alcohol content of these beverages. This does not mean that all drinks must be tested in administering the duty. Broad classes of drinks with roughly similar alcohol content could be determined. It may be appropriate to charge some beverages on a volume basis while others are taxed per degree of alcohol. However, where duties are to be charged on a volume basis, account should be taken of the average alcohol content of the standard measure of the beverage concerned when setting the rate of duty.

Beer

8.28 The excise duty on beer is levied at the pre-production stage, that is,

on the worts, which is an intermediate product between the initial mashing of the raw materials and the finished products. A uniform flat-rate allowance is made to domestic producers to cover losses between the production of the worts and delivery of the finished beer. No corrections are made in calculating the duty on imported beers. Six of the member states of the EEC apply the worts system. Greece applies a duty based on the weight of malt used in the production of beer. France, the Federal Republic of Germany and Denmark apply the excise to the finished product. This is the system favoured by the Commission of European Communities in its 1972 proposal to harmonise taxes on alcohol, because it offers the best means for achieving tax neutrality in international trade. Ireland has sought to retain the 'worts basis' of taxation in EEC discussions.

8.29 The Revenue Commissioners advised us that because the duty is levied on the worts, a 6 per cent allowance is granted for wastage. However, since some of the large breweries operate at wastage levels of less than 6 per cent, they gain a premium for efficiency. In general, the smaller brewers favour a finished product duty because in some cases wastage can amount to more than 6 per cent.

8.30 In principle, a finished product duty would be more logical and more equitable. However, the brewing industry has been built up on the basis of the existing structure of excise duty. Any sudden change in this structure would need to take account of the effects on the industry concerned. Subject to due consideration for the structure of the brewing industry, we recommend a change to a finished product duty.

Small Brewers

8.31 A scheme introduced in 1978 provides for a rebate of excise duty on beer produced by small brewers. This was intended as an alternative to changing from a worts basis to an end product duty which would favour small brewers. Full details of the scheme are in Appendix 12. This scheme does not accord with the principles we have established for the taxation of alcohol, i.e., every unit of potable alcohol should bear the same amount of tax irrespective of the circumstances of production or consumption. We therefore recommend that this rebate be abolished when duty on beer is changed to an end product basis.

Spirits

8.32 The excise duty on spirits is levied on undenatured spirits i.e. pure alcohol. The duty on Irish spirits warehoused for not less than 3 years is the main rate and is levied per litre of alcohol in the spirits. This rate governs the other rates of duty. An additional rate of duty is imposed on spirits which are either not warehoused or are warehoused for less than three

years. This additional duty was originally imposed as a surcharge on immature spirits. Under the Immature Spirits (Restriction) Acts, 1947 to 1972, spirits may not normally be delivered for home consumption unless they are, in the case of rum, at least one year old and, in the case of other spirits, at least three years old. The age restriction does not, however, apply to compounded spirits such as gin, liqueurs and certain vodkas. The surcharge was introduced in 1915 to help to maintain the competitive balance between spirits which were compulsorily retained in bond for three years before use, (thereby incurring storage costs and loss of the product through evaporation) and those which were allowed to be used without ageing. The present rate of the additional duty of £0.048 per litre of alcohol in the spirits has remained unaltered since 1926. This additional duty does not accord with the principles we have established for the taxation of alcohol. We recommend all potable alcohol be taxed at the same rate.

8.33 As regards perfumed spirits, the position is that the vast bulk of such spirits is suitably denatured (and thus rendered non-potable) and consequently is not chargeable with excise duty. Perfumed spirits which are made from undenatured spirits bear an excise duty charge. Undenatured spirits delivered to an Irish manufacturer of perfumed spirits are chargeable with excise duty in the ordinary way. In the case of the imported (undenatured) product, a special rate of duty is provided for, where the goods are "entered in such a manner as to indicate that the strength is not to be tested". This special rate is charged by reference to the liquid litre rather than by reference to alcoholic strength. The rate is designed as a convenience to importers of expensive perfumes, enabling them to pay on the liquid content of the perfume as an alternative to having samples taken for analysis by Customs for the purpose of applying the ordinary rate of spirits duty. The liquid rate of duty is cast at a sufficiently high level so as to inhibit importers from abusing it. It is not availed of to any great extent, as evidenced by the fact that the total amount of duty paid at that rate in 1982 was only some £6,000. Total excise receipts from perfumed spirits amounted only to some £43,000 in that year.

8.34 The Revenue Commissioners advised us that

"An exemption from excise duty in favour of perfumed spirits made from *undenatured* spirits would necessitate an expensive system of official control and would pose risks of serious evasion of excise duty. While most perfumed spirits are presently based on denatured spirits, an exemption which would enable undenatured spirits to be used duty-free would entail the serious danger that perfumed spirits would be re-distilled to potable standards or even that products would be produced which could be consumed as beverages without further processing. The delivery of potable spirits duty-free to Irish manufacturers of perfumed spirits would pose particular dangers of abuse and would demand the imposition of stringent excise controls which would

be extremely costly to operate and which could not in any event guarantee that abuses would not occur, bearing in mind the incentive provided by the high rate of spirits duty in Ireland.

The present regime operates satisfactorily, involves minimum costs in official controls and has not been the subject of complaint from traders or manufacturers."⁸

8.35 We recommend no change in these arrangements.

8.36 A number of other minor reliefs from excise duties are available. Details of these are given in Appendix 12. In the main they apply to spirits used for medical purposes or for use in art etc. We recommend no change in these arrangements.

Home-Made Alcohol

8.37 Spirits, beer and wine can all be made in the home, usually for home consumption but sometimes for sale. Over the past few years, making alcohol at home has become more popular, due to increased drink prices, the availability of home-brew kits and the improved techniques for making alcohol at home. It is likely that techniques will improve even further and that substantial growth will occur in home production of alcohol.

8.38 Legislation governing home-made alcohol dates from the Inland Revenue Act, 1880 with subsequent amendments in various Finance Acts between 1910 and 1922. Briefly, anyone distilling spirits for home consumption or for sale must have a licence. A private brewer must also have a licence even if the beer is for home consumption only. The cost of the licence depends on the rateable valuation of the house and varies from 20p to £2.50. If the rateable valuation of the house exceeds £15 the home-made beer is also liable to excise duty. There is no excise duty on beer where the house is under £15 valuation. No licence is necessary for home-made wine for domestic consumption, but a licence is required by makers of wine for sale. These provisions are in need of review and enforcement of them is haphazard. We think they are outmoded and should be removed.

8.39 In principle, we take the view that all home-made alcohol should be subject to excise duty in the same way as manufactured alcohol for sale i.e. on the alcoholic content. It would have to be assumed that home-made alcohol is similar in strength to the average alcoholic content of beer, wine and spirits for sale.

8.40 However, there are great difficulties with this approach in practice. The first problem is to identify the product liable for duty. Both the

⁸ Letter of 13 January, 1984.

ingredients and the equipment used in home-made alcohol are not exclusive to this process. For example, malt extract, which is the basic ingredient in home-made beer, is also used by commercial brewers as well as by some food manufacturers. It is likely that only a small proportion of malt extract produced or imported is used for home-brewing. It would be difficult to isolate this amount and single it out for duty. Similar problems attach to grape juice concentrate, as well as to the fruit, flowers and vegetables which can be used to make wine.

8.41 The second problem is one of definition. It has been suggested that excise duty be levied on home-brew kits but it is difficult to define precisely what these are, as they can consist of a bucket, a piece of siphon tubing and a stopper, all of which are common pieces of household equipment.

8.42 Finally, the extent of making alcohol at home is unknown. Clearly, it is not worth imposing a duty on home-made alcohol unless the yield can at least cover the costs of collection. The Drinks Industry Group believes that the making of alcohol in the home is a growing problem but still done on a small scale. The Revenue Commissioners are attempting to quantify the amount but are having difficulties because of the wide use of the basic ingredients for other purposes.

8.43 We conclude that the amount of home-made alcohol is still quite small. Irrespective of the size of the problem, however, administrative difficulties will remain which make the collection of excise duties on either ingredients or equipment used in home-made alcohol very difficult. We recommend, therefore, that no excise duty be levied on home-made alcohol for home consumption.

Table Waters

8.44 An excise duty of £0.372 per gallon applies to table waters. The term 'table waters' includes any aerated waters and any beverages (including syrups and other liquors intended to be consumed only in a diluted form) put up for sale in bottles, cans, casks or other closed containers or receptacles, other than

- (i) any liquor for the retail sale of which an excise licence is required,
- (ii) milk and milk products, whether or not flavoured,
- (iii) soups and broths, and
- (iv) fruit and vegetable juices which, in the opinion of the Revenue Commissioners, have not lost their original character through the addition of water or of other substances for sweetening, preservative or other purposes.

8.45 We see no justification on efficiency grounds for special taxes on table waters. We reject the argument that table waters which are used as 'mixers' for alcoholic drinks should bear some of the tax required to be raised to offset the costs of alcohol abuse. On grounds of efficiency, the costs imposed on the community by abuse of alcohol should only be borne by the consumers of alcohol. Table waters, although sometimes used in conjunction with alcohol, also provide a substitute for alcohol. We recommend that the excise duties on table waters be abolished.

Recommendations

8.46 We make the following recommendations:

1. Excise duties on alcohol may be justified on the basis that they charge the consumer for the external costs imposed on society by the consumption of alcohol. We have identified the main areas where costs and benefits arise but it is extremely difficult to quantify the net social costs in economic terms. In determining the excise duty on alcohol, account should be taken of the need to prevent the price of alcohol becoming significantly higher in the Republic than in Northern Ireland and Britain.
2. Excises on alcohol should vary only with respect to the alcohol content of different beverages.
3. Subject to due consideration for the structure of the brewing industry, the duty on beer should be levied on a finished product basis.
4. The rebate of excise duty on beer produced by small brewers should be abolished when duty on beer is charged on a finished product basis.
5. All undenatured spirits (i.e. those containing pure alcohol) should be charged to excise duty at the standard rate.
6. Alcohol for medical purposes or for use in any art should continue to be exempt from excise duty.
7. Excise duties on table waters should be abolished.

CHAPTER 9

EXCISES ON TOBACCO PRODUCTS

Introduction

9.1 In this chapter we examine the excise duties on tobacco. We consider the justification for such duties, review their present structures and make recommendations for change. Appendix 15 traces briefly the growth of cigarette smoking in Ireland and gives some statistics about the prevalence of the habit.

Present System

9.2 Excise duties on tobacco are charged on four main products; cigarettes, cigars, pipe tobaccos and other smoking and chewing tobaccos. The basis of assessment for cigarettes is different from that for other tobacco products. The duty on cigarettes is partly specific and partly *ad valorem*. At the present stage of EEC harmonisation, the specific element of the excise duty must be greater than 5 per cent but not more than 55 per cent of the total tax including VAT, on cigarettes in the most popular price category. Ireland opted for as high a specific element of excise duty as the EEC system would allow. The actual charging provision is specified as a fixed amount for 1,000 cigarettes — £26.60 per 1,000 plus a percentage of the retail price. This is now 14.8 per cent. The excise duties on other tobacco products are fully specific end product taxes i.e., the specific duties are applied to the finished weight. The rates are expressed as an amount per kilogram of tobacco and they vary according to the type of the tobacco involved. Full details of the present system of excise duties on tobacco products and an outline of their historical development are in Appendix 16.

CASE FOR EXCISE DUTIES ON TOBACCO

9.3 A wide range of physical illnesses is associated with smoking. Burdens are put on health and social services as a result of greater ill-health. Excise taxes on tobacco may be justified by the need to offset the costs imposed on the community by smoking. The decision to smoke is a personal decision, but the consequences of smoking are not simply personal and

private. Those consequences, economic and medical, affect not only the smoker, but every taxpayer.

9.4 Professor Muiris FitzGerald, Professor of Medicine at University College Dublin and Consultant in Respiratory Medicine at St. Vincent's Hospital, Dublin summarised the medical evidence of the impact of smoking on health as follows:¹

- (i) Cigarette smoking is related to lung cancer and heart disease.
- (ii) Cigarette smoking is the leading contributory cause of death from chronic bronchitis and other lung disorders.
- (iii) Women smoking during pregnancy have more complications than non-smokers.
- (iv) Babies born to mothers who smoke are significantly smaller at birth.
- (v) There is increasing evidence of damage to passive smokers. Side stream smoke — i.e. smoke generated by the cigarette while it smoulders — has a different composition to smoke inhaled by the smoker. It is high in substances which are carcinogenic. The level of carcinogens inhaled by non-smokers in enclosed places may be as high as that absorbed by smokers.
- (vi) Families of smokers have high rates of respiratory infectious diseases e.g. coughs, colds, flu and pneumonia.
- (vii) Filter cigarettes are less likely to lead to bronchitis but may lead to higher levels of carbon monoxide which increases vascular disease i.e. heart attacks and strokes.

Equity

9.5 Excise taxes on tobacco over and above the normal rate of tax applied to other goods would be fair where they simply charge smokers for the full costs of smoking. However, heavier taxation on tobacco as a source of revenue discriminates between people with the same incomes and different tastes. Evidence from household budget surveys shows that expenditure on tobacco is regressive. Taxes on tobacco are, therefore, likely to be regressive.

¹Meeting with Prof. Fitzgerald on 21 April, 1983.

Efficiency

9.6 Taxation of tobacco should offset the costs which are imposed on the community by the consumption of tobacco. A tax policy based on the principle of charging the smoker for the external costs caused by tobacco consumption is the best way of achieving economic efficiency. However, it is very difficult to establish the economic costs to the community of tobacco consumption. A number of studies has established that smokers

- (i) have twice the absentee rate of non-smokers,
- (ii) use the health services and visit general practitioners more often than non-smokers (this is significant with a fee per item system),
- (iii) are in hospital more often and for longer periods,
(A study of hospital bed occupancy related to cigarette smoking carried out in St. Vincent's Hospital, Dublin found that of 398 in-patients in the hospital during a one week period, 22.4 per cent had smoking-related diseases. Of the patients who had such illnesses 84.3 per cent were either current or ex-smokers.) and
- (iv) impose heavy burdens on social security systems. (Most early retirement on the grounds of ill-health in the United States is for smoking-related diseases.)

9.7 From studies in other countries there is evidence that the costs of tobacco consumption are substantial. In 1979, smoking in the United States accounted for an estimated \$5 to \$8 billion in health care expenses. In addition, the cost of lost productivity, wages and absenteeism caused by smoking-related illness was estimated at \$12 to \$18 billion. No work has been carried out in Ireland to assess the costs to the taxpayer of smoking in the community. However, with government expenditure on health and social welfare exceeding £2,000 million it is reasonable to suppose that smoking accounts for significant costs in terms of social welfare payments, health care expenses and lost production. Against this, the revenue yield from excise duties on tobacco products was £247.5 million in 1983. In addition, the Revenue Commissioners estimate that VAT on the sale of all tobacco products amounted to £70 million.

9.8 The Irish tobacco industry also makes a positive contribution to the economy. Any assessment of the net costs of smoking must take this contribution into account. A review² of the impact of the tobacco industry on the economy for 1982 summarises that contribution as follows:

²*The Irish Tobacco Industry — A Review of its Economic Impact for the year ended 31 December, 1982*, prepared by the Irish Tobacco Manufacturers' Advisory Committee (see Appendix 17).

- 1,881 people are directly employed by the three tobacco manufacturers and they are provided with pre-tax incomes of IR£19.7 million.
- In addition, the industry indirectly provides employment for many other people who are employed in the industries supplying the tobacco manufacturers and in the wholesale and retail trade.
- The wholesale and retail trade earn a gross IR£35.93 million from the sale of tobacco goods.
- Through purchases of goods and services, the industry contributed IR£17.56 million to other sectors of the economy.
- In relation to the balance of payments, at its simplest, it can be said that every twenty packet of cigarettes produced in this country saves one being imported (given that imports are a simple substitute for home produced goods). More positively, cigarette exports accounted for 18.6 per cent of total cigarette sales, although it must be remembered that the raw tobacco for all tobacco products manufactured in Ireland is imported.

9.9 In assessing the economic importance of the tobacco industry to the economy, it is important to take account not of how many people or resources are employed in the industry at present but rather how specific to the industry these resources are. While it is obvious that much of the labour force, plant and equipment and other resources used in the tobacco industry in Ireland now could only be redeployed into other sectors at considerable cost, it is not obvious that they do not have alternative uses. However, the high rate of unemployment does lend force to the argument that it would be difficult to replace jobs lost in any major contraction of the tobacco industry.

9.10 The Irish Tobacco Manufacturers' Advisory Committee in a submission stated that

- “(i) cost-benefit analysis is a severely limited technique. It is useful for choosing the best of several *similar* alternatives. The evaluation of the net social cost of an entire industry is practically impossible because no one knows what side-effects, i.e. costs and benefits, would occur if there were no sale of the products of the industry,
- (ii) in economic terms, the great majority of social reformers hugely exaggerate the net social cost of smoking. They widely misuse the social cost and cost-benefit analysis by counting in costs which are not social costs at all and by ignoring the very real benefits of smoking to smokers (over and above the price paid for smoking products). Their so-called estimates of net social cost tend, therefore, to be vast overestimates,

- (iii) even accepting the alleged causal relationships between smoking and smokers' health, the social costs assigned to smoking that might properly be called social costs in economic terms are so extremely difficult to measure that the social cost approach does not offer any viable practicable basis on which special taxes on tobacco (or on any other commodity) can be determined and justified on grounds of economic efficiency, and
- (iv) in any case, it seems self-evident that the yield of current excise duties on tobacco products in Ireland greatly exceeds any plausible guesstimate of the actual gross social cost of smoking. The inescapable conclusion is that the burden of excise duty on tobacco products for the most part amounts to a subsidy to non-smokers from smokers."

TABLE 12

'Popular' cigarettes (20 pack): Price and Tax Structures in EEC Countries as at Summer, 1983

Member State	Retail Price in ECU	Tax Component		Total Taxes	
		Excise %	VAT %	% of Retail Price	ECU (per 20 pack)
Belgium	1.009	64.94	5.66	70.60	0.712
Luxembourg	0.787	60.94	6.00	66.94	0.527
Netherlands	1.136	57.78	14.70	72.48	0.823
France	0.624	49.20 ⁽¹⁾	25.60 ⁽¹⁾	76.00 ⁽¹⁾	0.474
FR of Germany	1.590	62.89	12.28	75.17	1.195
Italy	0.949	55.59	16.67	72.26	0.686
Denmark	2.563	69.97	18.03	88.00	2.255
UK	1.912	60.76	13.04	73.80	1.411
Ireland	1.816 (IR£1.32)	55.10	18.70	73.80	1.340
Greece	0.468	56.10	— ⁽²⁾	±60.95	0.285

Source: Commission of the European Communities.

- Notes: (1) Since 1 July, 1983, France has levied a social security surcharge comprising a specific element and an *ad valorem* element; the new *ad valorem* element is calculated on the retail price whilst VAT and the *ad valorem* excise are calculated on the retail price excluding the surcharge (FF. 204.50 per 1,000 cigarettes). Infringement proceedings have been initiated by the Commission.
- (2) Greece has not yet introduced VAT. Turnover tax: 4 per cent (3.85 per cent on retail price) plus stamp duty 3.6 per cent on wholesale price without tax.
- (3) All percentages relate to retail prices.
- (4) The data for all member states are shown as at July, 1983 except for the Netherlands (August, 1983), Denmark (April, 1983), United Kingdom (March, 1983) and Greece (April, 1983).

Taxation of Tobacco in Other Countries

9.11 A further consideration which must be taken into account in deciding on the level of excise duty on tobacco is the level of taxation in other countries. The retail price of tobacco in Northern Ireland compared with the Republic of Ireland after allowing for currency differences is a particular constraint.

9.12 The tax burden on cigarettes varies within relatively narrow limits in EEC countries — see Table 12 above. In nine of the ten member states, the tax burden (excise plus value-added tax) falls between 60 per cent and 76 per cent of the retail price. Denmark is a marked exception to this rule, with a tax burden of 88 per cent — a figure which reflects the generally high level of all the Danish excises. The proportion of total taxes in the retail price of cigarettes in Ireland is 73.8 per cent; made up of 55.1 per cent excise duty and 18.7 per cent value-added tax. In 1979, the tax was only 63 per cent. The increase since 1979 is due mainly to a rise in the proportion of value-added tax from just over 9 per cent to almost 19 per cent. The retail selling price of 'popular' cigarettes in Ireland is now the third highest in the EEC. The total tax burden (that is, VAT and excise duty) in absolute terms on 'popular' cigarettes in Ireland is also the third highest in the EEC.

Conclusions

9.13 In principle, we believe that excise duties on tobacco may be justified on the grounds that there are significant external costs associated with tobacco consumption. We have identified the main areas where costs and benefits arise, but it is extremely difficult to quantify the net social costs in economic terms. In setting the level of taxation on tobacco we consider that the immediate objective should be to ensure that the combined incidence of excise duties and VAT on tobacco should not be so high as to result in higher retail prices in Ireland than in neighbouring jurisdictions, after adjustment for exchange rate differences. In the longer term it may be necessary to align the incidence of excise duties more closely with the other member states of the EEC. We recommend that, in determining the excise duty on tobacco, account should be taken of the need to prevent the price of tobacco in the Republic becoming significantly higher than in Northern Ireland and Britain.

DIFFERENTIAL TAXES ON TOBACCO PRODUCTS

9.14 Having drawn these broad conclusions we now turn to the differentiation of rates of any excise duties on various forms of tobacco. Two issues arise in relation to differential taxes on tobacco. The first is whether cigarettes should be taxed according to their tar and nicotine levels. The

second is whether the tax system should differentiate between cigarette smoking and other forms of smoking such as cigar and pipe smoking.

9.15 The latest evidence presented on the advantages of lower tar cigarettes shows that there is no safe cigarette available to smokers, but some cigarettes may be less hazardous than others, reducing the risks of smoking in a limited and selective fashion. In the light of research findings,³ we consider that differential taxes on cigarettes according to their tar and nicotine levels would not be well founded.

9.16 The latest evidence suggests that pipe smoking is harmful. Blood tests show that significant amounts of carbon monoxide are inhaled leading to increased vascular disease. The risk of lung cancer for pipe smokers is significantly lower than for cigarette smokers, but it is still greater than for non-smokers. In addition, pipe smoking has been directly related to lip cancer.

9.17 Cigar smokers do not tend to inhale and cigars are smoked mainly by the higher socio-economic groups who tend to smoke less anyway. In the United States where the typical cigar smoker smokes fewer than five cigars a day, the research findings suggest that some risk exists from smoking cigars, but for most diseases the risk is small relative to the enormous risk of smoking cigarettes. However, it is acknowledged that changes in the patterns of usage that would bring about increased exposure to smoke either through increased use of cigars or increased inhalation of cigar smoke, have the potential of producing risks similar to those now incurred by cigarette smokers.

9.18 The benefits of differential taxes on cigars and pipe tobacco are open to doubt since it has become clear that many heavy cigarette smokers who change to smoking pipes or cigars continue to inhale the smoke. This is most likely to happen in those who smoke small cigars which yield more tar and nicotine than most brands of cigarettes. The smoke of these small cigars may be inhaled just like cigarette smoke. A switch to pipe and cigar smoking may therefore not result in a corresponding reduction in the risk of diseases like lung cancer and coronary heart disease.

9.19 There are considerable differences between EEC countries both in the levels of the excise levied on cigars and smoking tobaccos and the way (specific, *ad valorem* or mixed) in which the rates are expressed. The major source of differences lies in the fact that some member states tax all manufactured tobaccos at broadly the same level, whilst others apply much reduced rates to smoking tobacco and cigars.

³The Changing Cigarette — a report of the Surgeon General.

9.20 The case for differential taxes on cigars and pipe tobacco is not clear-cut. We conclude on the basis of the evidence available that these products should be taxed at the same rate as tobacco generally.

Specific Versus Ad Valorem

9.21 In general, the excise duties on tobacco are relatively simple to administer and compliance costs are not significant when compared with other taxes. However, the present system of excises on cigarettes is unnecessarily complicated and is in large measure a compromise between the two extremes of wholly specific and wholly *ad valorem* systems which applied in the original six states of the EEC. A wholly specific excise would be much simpler and better accord with the principles of tobacco taxation.

9.22 We believe that since special taxes on tobacco are justified on the basis of charging the smoker with the social costs arising from smoking the rate of tax should be expressed as an amount per unit of tobacco, i.e. a specific excise. Furthermore, since we have rejected the argument for differential taxes on the various tobacco products, the basis of taxation should be the same for all tobaccos. This would suggest a specific excise based on finished weight of tobacco. We are aware, however, that there are practical difficulties in charging cigarettes in this way because the system chosen by the EEC is different.

9.23 The system of excise tax chosen by the EEC for cigarettes is part specific and part *ad valorem*. Ireland at present operates an excise with a specific element close to the maximum allowable. We believe that the excise duty on cigarettes should be based on finished weight of tobacco. However, it seems unlikely at this stage that a change in EEC policy can be brought about to enable a return to be made to that system. While we would reluctantly accept an excise on cigarettes which is levied per cigarette, we would advocate that it be wholly specific. We recommend that in future EEC discussions the Irish representatives seek to maintain the specific element of the excise duties on cigarettes at the highest possible level and that efforts be made to change EEC policy which favours a proportional or *ad valorem* tax when that policy comes to be reviewed.

9.24 Cigars, pipe tobacco and other smoking and chewing tobacco are at present subject to specific excises on the basis of a kilogram of the tobacco. We favour the retention of this basis of charge.

Recommendations

9.25 We make the following recommendations:

1. Excise duties on tobacco may be justified on the basis that they

charge the consumer for the external costs imposed on society by the consumption of tobacco. We have identified the main areas where costs and benefits arise but it is extremely difficult to quantify the net social costs in economic terms. In determining the excise duty on tobacco, account should be taken of the need to prevent the price of tobacco becoming significantly higher in the Republic than in Northern Ireland and Britain.

2. All forms of tobacco should be charged to excises at the same rate, or at equivalent rates where the bases of charge vary.
3. Subject to compliance with EEC directives, excise duties on tobacco should be wholly specific.

CHAPTER 10

TAXATION OF TRANSPORT

Introduction

10.1 There are three sources for the taxation of transport; excise duty on hydrocarbon oils, excise duty on motor vehicles, parts and accessories and motor vehicle duties (commonly known as road tax or car tax). In this chapter we examine these three forms of motor taxes. We consider the justification for such duties, review their present structure and make recommendations.

Revenue Raised

10.2 In 1982, £516 million was collected in excise duties on hydrocarbon oils, vehicles and accessories, tyres and tubes and in motor vehicle duties. The estimated yield for 1983 was £561 million. The largest proportion of this revenue comes from the excise duty on hydrocarbon oils as Table 13 shows:

TABLE 13
Revenue from Excise Duties on Motoring

Excise	1982		1983	
	£m	% share	£m	% share
Motor vehicle oils	246	47.7	273	48.7
— Petrol	51	9.9	66	11.8
— Road diesel	8	1.6	6	1.1
— LPG	139	26.9	123	21.9
Vehicles, accessories, tyres and tubes	72	14.0	93	16.6
Motor vehicle duties				
Total	516	100	561	100

Source: The Revenue Commissioners.

Case for Special Taxation of Transport

10.3 Special taxes on transport over and above the normal tax rate applied to other goods and services are discriminatory. Such taxes must be justified on efficiency grounds.

10.4 One justification for special taxes on motor vehicles is to cover the depreciation of roads. It is reasonable that such taxes bear some relation to the actual use of the roads and the damage caused to roads by particular types of vehicle.

10.5 Taxes on transport may also be justified by the need to offset the costs imposed on the community by air and noise pollution, traffic congestion, increased risk of death or injury and other damaging effects of the use of motor vehicles on third parties.

10.6 Taxes on motoring have an important role to play in regulating imports of private cars, thereby avoiding the costs incurred by the imposition of deflationary policies to reduce the balance of payments deficit. Transport accounted for 21 per cent of final use of energy in Ireland in 1982. Selective taxes on fuels may also be used to encourage energy conservation and to improve the balance of payments.

10.7 In considering special taxes on transport, account must be taken of the fact that transport is an important cost borne by the unsheltered sector. Taxes on inputs raise costs unless they are relieved by means of a credit, as generally happens with value-added tax. If special taxes on transport are higher than is justified, then efficient Irish businesses will be placed at a disadvantage *vis-à-vis* their foreign competitors.

Hydrocarbon Oils

10.8 Duties on hydrocarbon oil are divided into two main categories: mineral hydrocarbon light oil (mainly petroleum) and hydrocarbon oil (diesel oil, gas and vaporising oil, fuel and lubricating oils and white spirits). There is also a duty on gaseous hydrocarbons in liquid form (LPG). The duties are specific rather than *ad valorem*. Full details of these duties are in Appendix 18.

10.9 The rates of duty on hydrocarbon oils and LPG are as follows (February, 1984):

petrol (premium grade) 108.1 pence per gallon,
auto-diesel 78.2 pence per gallon,
auto-LPG 76.7 pence per gallon.

£345 million was collected in excise duty on fuels in 1983. Petrol accounted for about 79 per cent of this total.

10.10 Excise duties on fuel are the most satisfactory form of special taxation on motoring. They charge motorists in relation to their use of the road network and help to offset the costs imposed by pollution and traffic congestion. The duty is easy to administer and difficult to evade. Ideally, we would favour the consolidation of all special taxes on motoring into an excise duty on fuel. This would mean an increase of approximately 63 per cent in the 1983 levels of excise duty on all hydrocarbons used in motoring, about 65 pence on a gallon of petrol.

10.11 We acknowledge, however, that there are constraints on this policy. Smuggling of road fuel on a commercial basis from Northern Ireland has grown at current duty levels. Further substantial duty increases in the Republic of Ireland would give added encouragement to smuggling. In addition, loss of business for petrol retailers in border areas is now a serious problem. A greater differential would spread these difficulties over a wider area and result in more lost revenue to the Exchequer. It would create further inequalities between people who live in border areas and other parts of the country. We recommend, therefore, that the highest possible proportion of special taxes on motoring be raised in excise duties on hydrocarbon oils, subject to the need to prevent significant price differentials arising between Northern Ireland and the Republic of Ireland.

10.12 The excise differential between petrol and auto-diesel is quite substantial (29.9 pence per gallon at February, 1984). The differential in the rate of excise duty on petrol and diesel was first introduced in April, 1952. At that time the removal of an expensive component of petrol (power methylated spirits) would have resulted in a decrease of 1½d in the price of petrol. It was decided to increase the excise duty on petrol by this amount. In 1956, the differential in the duty on petrol and diesel was widened by 5½d. This was justified as a budgetary measure on the grounds that petrol was less essential than diesel which was used mainly by lorries and buses.

10.13 The differential in the duty remained unchanged until the mid-nineteen seventies when duty increases were concentrated on petrol, mainly for energy conservation and balance of payments reasons.

10.14 The differentials in the rates of excise duties on petrol and diesel in EEC countries are shown in Table 14. Diesel oil is taxed at lower levels than petrol in all EEC countries. The EEC Commission's attitude is expressed as follows:

"Whereas in the past diesel oil was used by and large only in the commercial and productive sectors, the proportion of motor vehicles using it is now increasing rapidly. As the present levels of excise duty on this product in many countries do not encourage energy savings, it would be desirable for taxation on motor fuels to be aligned, i.e. the lowest levels of excise duty on diesel oil should be increased. Steps should also be taken to ensure that the structure of excise duties does not encourage substitution by other forms of energy such as liquefied petroleum gas which offer few or no advantages from the viewpoint of energy policy".¹

Table 14
Differentials in the Rates of Excise Duties on Diesel and Petrol in EEC Countries, July, 1981

Country	Differential ECU/hl	Differential ranking
Belgium	12.0	6th
F. R. of Germany	2.5	10th
Denmark	19.8	2nd
France	11.1	7th
United Kingdom	3.5	9th
Greece	17.7	3rd
Italy	30.4	1st
Luxembourg	12.0	5th
Netherlands	12.4	4th
Ireland	8.2	8th

Source: Communication by the Commission of the European Communities to the Council [Com (81) final].

Note: There is a small difference between the figures for Belgium and Luxembourg. This is not shown in the table due to rounding.

10.15 The lower rate of excise duty on diesel is defended on the grounds that diesel is used mainly by goods vehicles and is a more efficient fuel than petrol for this type of transport. The price difference also encourages high mileage motorists to convert to diesel-engined cars. Such cars can provide energy savings of 30 per cent or more compared to petrol-engined vehicles. However, the capital costs of diesel cars are generally higher.

10.16 In 1976, excise duty was imposed on LPG. The rate of duty since then has been kept in line with that on auto-diesel rather than on petrol as it was argued that a comparison between LPG and auto-diesel for tax purposes was fairer and more reasonable. LPG has some advantages over petrol. It is approximately 10 per cent more efficient than petrol on the basis of energy consumed per kilometre. Emissions of carbon monoxide and nitrogen oxides are lower than for petrol.

¹ COM (81) final, 11 September, 1981.

10.17 The emergence of a favourable rate of tax on diesel was not the result of any coherent policy and there is no clear statement of current policy in relation to the use of these fuels. The fact that diesel and LPG are more economical fuels could point towards a higher rate of duty than on petrol, if taxation of fuel is seen mainly as a means of charging for the use of the road network. It is also important to note that relative differences in excise duties may be absorbed by the oil companies in their efforts to match supply and demand of particular oil products. Despite these considerations, we believe that some differential in favour of LPG and auto-diesel is justified while these fuels are used mainly for industrial purposes. However, the present differential seems rather high, given that vehicles using diesel and LPG use the roads equally with other vehicles and also contribute to traffic congestion and noise pollution. We recommend that LPG and auto-diesel should bear the same rate of duty. We also consider that the present differential over petrol is higher than is justified and should be reduced. However, in fixing the level of these duties, constraints will be imposed by the price of these fuels in Northern Ireland.

10.18 Lead in petrol contributes significantly to atmospheric pollution. The damage caused by lead pollution to health, particularly of young children, is well documented. We recommend that leaded petrol bear a higher rate of duty than unleaded petrol. While there is no unleaded petrol available in Ireland at present, the introduction of a significant price differential would encourage its earlier provision.

10.19 Rebates are allowed for diesel used in scheduled road passenger services (£15.42 per hectolitre) and for rail services (£15.46 per hectolitre). The main beneficiary of this tax concession is CIE but there are about 30 private operators licensed to operate approximately 100 scheduled services, mainly in rural areas. This tax concession is a subsidy to public transport but it is inefficient because it does not encourage public transport operators to conserve energy. We recommend that this rebate be abolished and that operators of road passenger and rail services bear the full cost of diesel fuel. However, a public transport system can reduce national energy consumption and the costs of congestion. If there is a case for subsidising public transport, we would favour a system of direct subvention rather than subsidisation through tax concessions on inputs.

EXCISE DUTY ON MOTOR VEHICLES, PARTS AND ACCESSORIES

10.20 Excise duty on private cars brings in over 80 per cent of the duty under this heading. Excise duty on private cars (category 'A') is charged at a rate of 64.5 per cent for cars over 2,000 cc (16 h.p.) and at 54.5 per cent for other cars. Goods vehicles (category 'B') are charged at a rate of 11.5 per cent. Full details of these duties are contained in Appendix 19.

Private Cars

10.21 Motor cars, motor cycles and certain mini-buses are classified as category 'A' vehicles. Although the burden of the excise duty is borne by purchasers of new cars, in the long run all car owners are affected by the excise duty as second-hand prices are related to the price as new including duty.

10.22 Excise duties are levied on motor vehicles in four EEC countries including Ireland. The other member states have no excise duties on motor vehicles, however, some have higher rates of value-added tax. Compared with the other three countries Ireland takes a much higher proportion of total tax revenue from vehicle excise duties as Table 15 shows.

TABLE 15

Vehicle Excise Duty as a Share of Total Tax Revenue and Gross Domestic Product in Four Countries, 1981

Country	Share of Total Tax Revenue	Share of Gross Domestic Product
	%	%
Denmark	1.82	0.78
Ireland	4.57	1.33
Netherlands	1.24	0.33
United Kingdom	0.16	0.05
Ireland's ranking	1st	1st

Source: Statistical Office of the European Communities.

10.23 Total abolition of motor vehicle excise duties on a revenue neutral basis would increase the price of petrol by about 37 pence (at 1983 duty levels) with pro rata increases for other fuels. However, this would be likely to lead to a great increase in the purchase of new cars. The recent export trade in cars suggests that the tax exclusive cost of cars is lower here than in the United Kingdom. This could arise if part of the tax on cars is borne in the form of lower margins of manufacturers or dealers. Any reduction in the tax on cars could therefore lead to an increase in the basic cost of cars. The balance of payments would deteriorate. We recommend that substantial motor vehicle excise duties be retained on private cars.

Goods Vehicles

10.24 We believe that motor vehicle duties (road tax) are a more suitable form of taxation for commercial vehicles than excise duties. We recommend that excise duty on goods vehicles be removed and consolidated into the restructured road tax recommended in paragraph 10.39.

Parts and Accessories

10.25 Duties are levied at a rate of 25 per cent on all parts and accessories which are imported. Home-produced parts are not subject to excise duties. Tubes and tyres form a separate category. Imported tyres and tubes carry a 10 per cent duty and home-produced items 5 per cent. Full details of these duties are in Appendix 19.

10.26 These duties serve little purpose. The revenue yield is insignificant in the overall context of excises on motor vehicles. Parts and accessories accounted for 6 per cent (£7 million) and tyres and tubes for 2.4 per cent (£3 million) in 1983. We take the view that these excise duties only discourage people from maintaining their vehicle at an efficient and safe standard. The duties have been reduced recently in part recognition of this disincentive effect. We recommend that these excise duties be abolished completely.

MOTOR VEHICLE DUTIES

10.27 Motor vehicle duties (road tax or car tax) are levied on a large range of vehicles. There are a total of 13 classes and the manner in which the tax is applied varies greatly from one vehicle type to another. (See Appendix 20). The revenue from road tax comes largely from private cars and goods vehicles.

10.28 Many of the vehicles taxed do not use the roads extensively and this is reflected in their rate of tax. For example, a tractor is subject to a flat-rate of £15 and a forklift truck, which would be used rarely on the road, is subject to a tax of £2 per horse power. This contrasts with the tax on a family car of 12 horse power which is subject to a tax of £10 per horse power (£120 per annum). Other categories e.g. taxis and hackneys have traditionally been taxed at a special rate (£30 maximum per taxi and £50 maximum per hackney). A number of vehicles are exempt from road tax including ambulances, fire brigade service vehicles, road rollers, refuse carts, government-owned vehicles and vehicles constructed or adapted for use by certain invalids. The variety of classifications and the different treatment given to particular types of vehicles contributes to inefficiency.

10.29 There is scope for rationalisation of motor vehicle duties. We see no justification for collecting small sums of revenue from categories of vehicles which have a limited use of the roads. Nor can the tax justifiably be raised for such vehicles to cover the cost of collection. We therefore recommend the abolition of road tax on mobile machines, forklift trucks, agricultural tractors, general haulage tractors, excavators, trench diggers,

and other vehicles not primarily used on the roads. If there is a need to register such vehicles, the registration charge should cover the costs of administration.

Private Cars and Motor Cycles

10.30 In 1983, there were 718,555 private cars under current licence and 25,600 motor cycles. Registrations of motor cycles have been declining steadily from 1975 reflecting increasing incomes and higher levels of car ownership.²

10.31 Road tax on private vehicles meets many of the criteria for special taxation on motoring. The question arises as to the basis on which this should be imposed. At present, motor vehicle duties are related in a progressive way to the cubic capacity of the engine. Possible alternative bases are to provide a rebate related to the age of the car or to base the tax on fuel efficiency ratios.

10.32 The Society of the Irish Motor Industry suggested to us that a good case can be made for a reduction in the rates of motor vehicle duty for older cars, particularly cars of high engine capacity. The motor trade finds it difficult to dispose of large used cars because of the double impact of high insurance premiums and high rates of road tax. Such large cars represent a useful economic asset and it appears wasteful to have their value drastically reduced because of the high burden of duty which attaches to them.

10.33 We do not favour a rebate in the duty for older cars for a number of reasons. Firstly, it would increase administrative costs to be borne by the general taxpayer. Secondly, a reduction in duty which would increase the value of such vehicles would confer no economic advantage to the country at large. Thirdly, when our proposals for charging benefits-in-kind in respect of cars provided by employers are implemented, we believe there will be a reduction in the number of large cars being provided. This will lead to an improved balance in the supply and demand for such cars second-hand.

10.34 As far as fuel efficiency ratios are concerned, the tax would have to be based on manufacturers' trials under test conditions. These may differ significantly from the fuel efficiency achieved by motorists. On balance, we recommend that motor vehicle duties continue to be related to the cubic capacity of the engine.

² C. Murphy and S. Smith: *The Retail Motor Trade 1983-1990*. AnCO, 1983.

10.35 At present there are five different rates of road tax on private cars and nine different rates on motor cycles. Such rate structures seem to us to have very little basis and are much too complicated. We think that simplification is desirable and we note that in the United Kingdom the same level of road tax is payable on all cars. To simplify matters we recommend that this be done in Ireland also. The higher rate of motor vehicle excise duty on cars over 2,000 cc effectively translates into a higher rate of tax on private cars over 16 horse power. If necessary this differential could be increased to compensate for the reduction in road tax on such cars. One rate of duty on motor cycles would also be appropriate.

10.36 One of the difficulties with road tax is the high level of evasion. According to estimates made by the Department of the Environment, evasion could be as high as 20 per cent. Contributory reasons are lack of enforcement and low penalties if caught. Unlike excise duty on fuel, road tax can be evaded quite easily. For this reason we would prefer to see higher fuel taxes but for the constraints imposed by border trade. In our report on administration we propose to examine methods of increasing the efficiency of collection of road tax, including the possibility of handing it over on an agency basis to motor insurers.

Goods Vehicles

10.37 In 1983, there were 70,000 goods vehicles registered. The goods vehicle market divides into three categories: light, medium and heavy vehicles. In the past decade the number of light vehicles has declined while those in the medium and heavy categories have increased. The forecast is for goods vehicles to get even larger subject to the limits imposed by legislation.³

10.38 Road tax on goods vehicles was introduced in 1952. There were some revisions of rates in 1973 and again in 1983. Long intervals between changes, followed by small increases have meant that the rates have substantially declined in real terms. The minimum rate is now £22 for a light vehicle. The maximum rate is over £1,100 for the heavier articulated truck.

10.39 It has been estimated that goods vehicles contribute to the costs of depreciation of the road network properly attributable to them but the tax on smaller and lighter vehicles covers their costs by a factor of two.⁴ The road damaging effect of any vehicle is determined by the weight it carries on each axle rather than by its overall weight: thus a vehicle with a large

³ C. Murphy and S. Smith: *The Retail Motor Trade 1983-1990*. AnCO, 1983.

⁴ B. Feeney. *Paying for Road Damage*. Chapter 28 of "Promise and Performance: Irish Environmental Policies Analysed". Edited by John Blackwell and Frank J. Convery, University College Dublin, 1983.

number of axles may cause less damage than a vehicle of lower overall weight which has fewer axles. The current basis of taxation, viz unladen weight, is unsuitable as the costs imposed by each type of vehicle bears little relationship to its unladen weight. It is desirable that road tax be levied on trucks according to their gross vehicle weight and number of axles. The EEC Commission has proposed⁵ the reform of national road tax systems on these lines, although final approval by the Council of Ministers has not yet been obtained. This system determines road taxes by considering the level of payments which, together with fuel taxes, are required to cover at least the marginal cost of maintaining and renewing the road network. Given the current state of Irish roads and the need to encourage the purchase of less damaging vehicles, we recommend that this basis of taxation be introduced in Ireland as soon as possible.

Public Service Vehicles

10.40 Large and small public service vehicles, mainly buses and taxis, are taxed at concessionary rates. In principle, these vehicles should be taxed at the full rate and any subsidy which is necessary to support public transport given by way of direct grants. We recognise, however, that these vehicles form part of an integral system of public transport. An efficient bus service can relieve traffic congestion and reduce energy consumption. Taxis can provide a complementary service by operating a shuttle service in cities, enabling business people and shoppers to move around more quickly and discouraging them from using their own cars.⁶ Unlike the fuel concession to large public vehicles which discourages energy efficiency, these concessionary rates have no negative side-effects and so may be considered as a convenient method of subsidising public transport. However, they should be included in a tax expenditure budget.

Exempt Vehicles

10.41 Most exempt vehicles are owned by government, local authorities and health boards and include post office vans, garda vehicles, fire brigades and ambulances. Government-owned vehicles form the largest category of exempt vehicles. While in principle all vehicles which use the road regularly should pay road tax, there may be a case for continuing the exemption for other government-owned and exempt vehicles. In many cases payment of road tax would be a circular payment of public funds from one department/local authority to the Department of the Environment.

⁵ Draft Council Directive on the Adjustment of National Taxation Systems for Commercial Road Vehicles R/2904/78 (Trans 165), November, 1978.

⁶ Report of the Transport Consultative Commission on Passenger Transport Services in the Dublin Area. March, 1980. p.110-11.

Vehicles Used by Invalids

10.42 The road tax exemption for vehicles used by invalids was introduced in the Finance Act, 1968. In order to qualify for the exemption, an invalid must be certified by a doctor to be "wholly or almost wholly without the use of each of his legs". The vehicle must also be specially constructed or adapted for use by the invalid as driver or passenger. There were 969 such vehicles in 1980.

10.43 Two further concessions introduced since 1968 are now substantially more valuable than road tax exemption. Since 1976, a full rebate of excise duty and VAT on the purchase of a new vehicle is given to invalids who qualify for road tax exemption. This is by far the greatest tax concession as the tax element now makes up to 47 per cent of the retail price of a new car. In addition, there is full rebate of excise duty on petrol up to 600 gallons per annum. With excise duty at 108.1 pence per gallon this too is now a more substantial concession than road tax exemption.

10.44 Together these three concessions provide considerable assistance to qualifying invalids. However, they suffer from a number of faults. Firstly, the value of the concessions is not related to the costs incurred in constructing or adapting vehicles. The costs may vary between individual invalids. The most valuable concession, rebate of excise duty and VAT on the vehicle, is related to the value of the car; the higher the price of the vehicle, the higher the value of the concession. Secondly, the concessions take little account of need. Some invalids may receive substantial compensation awards, others may receive none. The present system does not discriminate between those people who have sufficient capital to purchase a car and those who do not. Finally, the concessions are very limited in scope, available to a very small group of invalids. If the present concessions were more discriminatory, the scope of the concessions could be extended to include other invalids who also have problems with mobility.

10.45 From 1979, full rebate of excise duty and VAT on vehicles for use by invalids became available to "severely disabled persons"⁷ if the cost of adaptation equals or exceeds 30 per cent of the value of the car excluding taxes. If the cost of adaptation is less than 30 per cent of the value of the vehicle, a refund of excise duty and VAT on the costs of adaptation only is available. This scheme is wider in scope and less wasteful as it is related to costs of adaptation.

⁷ Value-added Tax (Refund of Tax) No. 10 Order, 1979.

10.46 While assistance is necessary to encourage invalids to increase their mobility, it might be preferable if the present tax concessions were replaced by direct grants related to the costs of adaptation and construction and individual needs. Such a grant is already available from the Department of Health for invalids who do not qualify for existing tax concessions. This is a matter ultimately for the health authorities who must determine how state aid to improve mobility of invalids can be applied most efficiently.

Road Fund

10.47 The Road Fund was set up under the Roads Act, 1920 to finance expenditure on roads. The original intention was that the Fund would derive its income from motor vehicle duties. In 1966 part of the income from motor vehicle duties was appropriated for general Exchequer purposes. This continued until the Road Fund was abolished on 1 January, 1978.

10.48 A submission from the Society of the Irish Motor Industry argued in favour of the payment of motor vehicle duties into a separate fund to be devoted to expenditure on roads:

"The existence of a Road Fund lends a certain transparency to the receipts and payments which make the duties far more acceptable to the motorist as he can clearly see evidence that taxes demanded from motorists as a special category within the community are devoted specifically to a purpose directly associated with the use of motor vehicles".

The submission also argued that the Road Fund would assure a specific sum of money each year to those responsible for maintenance and improvement of roads thus obviating the need to compete for this allocation against all other demands on Exchequer resources.

10.49 The Road Fund requires the assignment of revenues from specific taxes to particular purposes. In our first report we indicated our general attitudes to assigned revenues.⁸ We opposed the concept of assigned revenues on the grounds that

- (i) it is desirable that revenue be allocated on the basis of need rather than by reference to the amount raised under individual tax heads, and
- (ii) separate taxes increase administrative and compliance costs.

⁸ Paragraphs 22.1 to 22.5.

10.50 We see no reason to modify our general attitude to assigned revenues in relation to expenditure on roads. While we believe that special taxes should be levied on those who use the roads which should effect a charge for depreciation of the road network, it is not appropriate that this depreciation charge should always be equivalent to road investment. We do not recommend in favour of the restoration of the Road Fund.

Recommendations

10.51 We make the following recommendations:

1. Taxes on motoring should cover the depreciation of the road network and the costs imposed on the community arising from motoring in the form of air and noise pollution, traffic congestion and road accidents. These taxes should be imposed on all users. Further taxes may be used to regulate imports of private cars and to reduce consumption of energy. These additional taxes should not apply to the traded sector.
2. The highest possible proportion of special taxes on motoring should be raised in excise duties on hydrocarbon oils, subject to the need to prevent distortion of trade between Northern Ireland and the Republic.
3. Some excise differential between petrol and auto-diesel should be maintained while diesel is used mainly for industrial purposes. The existing differential should be reduced. Auto-diesel and LPG should bear the same rate of duty.
4. Leaded petrol should bear a significantly higher rate of excise duty than unleaded petrol.
5. Rebates for diesel used by public transport operators should be withdrawn and replaced if necessary by a direct subvention.
6. Excise duties on motor cars, motor cycles and certain mini-buses (Category 'A' vehicles) should be retained.
7. Excise duty on goods vehicles (Category 'B') should be abolished.
8. Excise duties on parts and accessories, tyres and tubes should be abolished.
9. Road tax on mobile machines, forklift trucks, agricultural tractors, general haulage tractors, excavators, trench diggers, and other vehicles not primarily used on the roads should be abolished.
10. The number of different rates of road tax on private cars and motor cycles should be reduced.

11. Road tax on heavy goods vehicles should be related to gross vehicle weight and the number of axles per vehicle.
12. Concessionary rates of road tax for large and small public service vehicles should be continued.
13. The Road Fund should not be restored.

CHAPTER 11

BETTING AND GAMBLING

Introduction

11.1 In this chapter we examine betting duties, review their present structure and make recommendations for change. We also examine the excise duties on gaming premises licences and gaming machine licences. However, we first consider the nature of gambling and its appropriate treatment for tax purposes. An outline of the present system of duties and its historical development is in Appendix 21.

Gambling

11.2 Two Royal Commissions have reported on gambling in the United Kingdom; no similar studies have been made in Ireland. The most recent of these in 1978 gave a commendably clear description of the issues involved.

"Gambling is variously described as wholly evil; a mainly innocent leisure activity; an important source of revenue for the Government; a useful earner of foreign exchange; a valuable stimulus for tourism; an activity which has led to addiction with adverse consequences; and one in which the interests of the consumer (the punter) are not adequately cared for by anybody so that he or she is at the mercy of gambling promoters".¹

11.3 Certain questions therefore arise: is betting so heinous that it should be outlawed like certain drugs? Is it a legitimate activity but one which when exercised to excess carries such costs to the community that it should bear a share of these costs? Is it an activity which will happen anyway and which should be positively encouraged for the sake of tourism (and the luring to Ireland of gamblers who would otherwise spend their money elsewhere)? Is it a service which should bear its share of indirect tax, either in the form of VAT or excise duty, like any other form of activity?

¹Royal Commission on Gambling, Final Report, July, 1978, p.6.

The Suppression of Betting

11.4 The total suppression of organised betting has been attempted in other countries and the results have not been encouraging. No Irish government has expressed a desire to follow such a course and we believe that it would be neither desirable nor practicable to do so. Furthermore, one form of gambling, namely betting on the totalisator, is actually done through a state agency.

The Costs of Gambling

11.5 There is no doubt that there are individuals who gamble to excess with disastrous results for their dependants. Unlike studies on alcoholic drink or smoking, however, no research has attempted to quantify the costs to the community at large. Moreover, is it not possible to estimate the amount of money involved in gambling; firstly, because so much gambling is not done through organised channels, such as bookmakers or the Tote; secondly, because a large proportion of the funds is 're-invested' i.e. winnings on one bet are merely transferred into another bet but the punter produces no fresh funds; and thirdly, because all parties agree that even betting on organised sporting events is increasingly done outside the state or illegally within the state — in both situations no records are available.

11.6 It is argued that betting does not create national wealth. This is true, as it is true also of many other activities which reward their promoters and some of those who engage in them. The connection between betting and the bloodstock industry, the greyhound industry and much sporting activity which has implications for tourism and service industries has, however, been traditionally close. While there are certainly people who breed horses and dogs and who never bet on their progeny, it is unlikely that the bloodstock and greyhound industry in Ireland and the ancillary business of racing, with its many service components, would continue to exist, let alone thrive, if there were no betting in existence. The Commission of Inquiry into the Thoroughbred Horse Breeding Industry, set up under the Chairmanship of Lord Killanin in 1982, has the consideration of bookmaking as part of its brief and bookmaking cannot be isolated from the taxation of betting.

Justification for Betting Duties

11.7 It may be argued that betting duties are a substitute for income tax on betting winnings. At present, gambling winnings are not liable to income tax unless they are taken into account as receipts of a trade, profession or vocation, such as in the case of a bookmaker or casino