Second Report
of the
Commission on Taxation

DIRECT TAXATION
The Role of Incentives

March 1984

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ARNA FHOILSIÚ AG OIFIG AN tSOLÁTHAIR.

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PREFACE

1. This is our second report on the Irish tax system made 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".

Our Approach

2. Our first report published in July, 1982 contained our views on the general system of direct taxation which should apply in Ireland. This report is concerned with the modifications to that system which might bring additional improvement in economic performance. The principles which should govern the making of these modifications or incentives are discussed in part one of this report. In part two of this report we give our views on how these principles should be applied in practice. Part three deals with implementation of the proposals.

3. In our examination of incentives we have been conscious that

(i) the existing high level of taxation is a serious disincentive to productive effort,

(ii) a major contributory factor to high rates of taxation has been the erosion of the tax base by the very large number of incentives which have been provided,

(iii) tax avoidance is widespread and has been facilitated by the provision of special incentives, which inevitably provide scope for manipulation, and

(vi) the cost of incentives must be matched by higher taxation on other activities.

Membership of Commission

4. Camilla Hannon resigned from the Commission in September, 1982 following her appointment to Seanad Éireann. She made a very valuable contribution to the preparation of our first report. We wish to record our thanks to her for her commitment to our work.

Secretariat

5. There have been a number of changes in our secretariat. Following completion of work on our first report, William Hennessy returned to the Office of the Revenue Commissioners and was replaced by Séamus Reic in June, 1982. Paul Molloy returned to the Department of Finance on his promotion in October, 1982 and was replaced by Mary Honan. She was in turn replaced by Deirdre Dowdall in March, 1983. John Hamill was replaced by Kealin Ireland in October, 1983.

6. We sought specialist advice to supplement the work done by our own secretariat. Professor John Bristow of Trinity College Dublin prepared a paper for us on "The Taxation of Manufacturing Industry". The Analysis Section of the Department of Finance prepared a report for us on the benefit of free depreciation. Professor Cedric Sandford of the University of Bath undertook a critical review of the final draft of this report. We are very grateful for their contribution to our work.

7. To date the Commission has met formally on 57 occasions over a period of 65 days. All meetings have been held in Dublin.

Consultations

8. Contact was maintained with the Office of the Revenue Commissioners and the Department of Finance. Other Government Departments and the Central Statistics Office were asked for information on aspects of our work which were relevant. Consultations were held with certain state-sponsored bodies and with trade, management, labour and professional organisations both on a formal and informal basis. Some bodies made submissions to us subsequent to the publication of our first report. These are listed in Appendix 1.

9. Since the incentives recommended in this report are considered in the context of the proposals made in our first report, the Commission has found the work of explaining the first report particularly useful in helping to clarify the issues raised in this report. Criticisms of the first report have been examined and taken into account in the preparation of this and the other reports.

10. The Chairman and Secretary of the Commission visited the EEC Commission in Brussels to discuss certain aspects of fiscal incentives and their implications. Discussions have also been held in London with Government officials and experts in the fields under review. Two meetings have been held with the Chairman and members of the Committee on Economic and Monetary Affairs of the European Parliament, one in Brussels and one in Dublin.

Format

11. The format and style of the first report has been followed to a large extent. The use of the pronoun 'he' has been made in the same context as before embracing both male and female.

Acknowledgements

12. Once again we must acknowledge the help given to us in our work by a very large number of organisations and individuals. The co-operation begun in the course of our first report has continued and been extended.

13. The contribution of the secretariat has continued to be outstanding. The Secretary, Donal de Buitléir and the other members looked after the launching of the first report while maintaining an impressive standard of work on the second and other reports. In view of the difficulties caused both by the nature of this report and the changing background against which it had to be written, we consider their contribution to have been exceptional.

Further Reports

14. The enquiries for our third report dealing with indirect taxation have been completed in conjunction with this report. A number of subjects within our brief remain to be considered, including tax administration and measures required to deal with tax evasion. We shall wish also to consider the appropriate overall balance of direct and indirect taxation and its implications.

INTRODUCTION

1. Our first report set out our views on the general system of direct taxation which should apply in Ireland. The key elements of the taxation system we proposed were

(i) Income tax should remain the main source of direct taxation in Ireland.

(ii) Income tax should be charged at a single rate on all income arising in the personal and corporate sectors.

(iii) The single rate of income tax should be lower than the current standard rate and should apply to a much more accurate, equitable and comprehensive definition of income than at present, including wages, salaries, profits, realised capital gains, lump sum receipts, gifts, inheritances and other windfalls.

(iv) The extraordinary range of exemptions and deductions from personal income for tax purposes which narrow the tax base and result in higher tax rates should be abandoned. Only standard personal allowances given in the form of tax credits should remain.

(v) The redistributive function of the tax and public expenditure systems should be achieved through direct payments at the bottom of the scale, through the choice of a level of personal credit and the tax rate in the middle income range and through the imposition of a progressive direct tax on expenditure at the top of the scale.

(vi) Social insurance contributions should be replaced by a social security tax levied at a single rate on all income as we defined above.

(vii) The tax system should be adjusted systematically to deal with the distortions arising from inflation through indexation of progressive tax structures and capital/income adjustments to take account of changes in the real value of liabilities and income-producing assets.

(viii) Tax borne at the company level should be available for imputation in full to the shareholder when distributions are made out of the underlying profits.

(ix) The different treatment of individual and family for income and capital tax purposes should be replaced by uniform treatment in which the family is the basic unit.

2. These proposals would produce major economic benefits. The existing system of taxation seriously inhibits productive effort but the new basic structure would improve substantially incentives to work, innovate and develop the Irish economy. A necessary complement to these broad reforms is a reduction in the large number of special reliefs in the present code which have added to the distortions and complexity of the present system. The need for incentives merely to offset the disincentive effects of the present ramshackle tax structure would be removed.

3. Our first report had considerable implications for industrial policy. It suggested changes which would remove disincentives for savings and investment relative to consumption. It would favour the use of labour relative to capital equipment and encourage more accurate assessment of profits. It would reduce taxation for companies and individuals who devoted their energies to continued expansion, while taxing more heavily capital which was being withdrawn from the productive process to be used for personal consumption. It implied a better climate for the development of companies in Ireland, so long as they devote their resources to productive effort, while freeing them of the need to exploit a complex and shifting system of incentives which diverts managerial resources and distorts decisions.

4. This report is concerned with the departures from the basic system of taxation we have proposed which may be necessary to ensure the development of the national economy. Because the proposed general system is a vast improvement on the present system, the need for these departures or incentives is limited. In part one of this report we examine the principles which should govern the provision of incentives. In part two of the report, we examine, by reference to these principles, existing and possible new incentives and make recommendations. We stress that these recommendations should apply only in the context of implementation of the main proposals in our first report.

Strategy

5. The increase of living standards through the achievement of higher sustainable levels of economic growth is the primary objective of economic policy. Employment is an immediate and pressing objective. These goals can only be reached by raising growth in the unsheltered sector. While economic policy must be concerned with the efficiency of certain sheltered activities which are crucial to the competitiveness of the unsheltered sector, incentives aimed at increasing the level of national income should be concentrated on the unsheltered or trading sector.

6. Investment in the trading sector must be made more attractive. One of the themes of this report and of our first report is that there are too many incentives for activities which do not contribute directly to exports or import substitution. Many of these aided activities are virtually risk-free when compared with the hazards of investing in the trading sector. There is an urgent need to redress the balance in the risks and rewards attaching to different forms of investment in favour of the trading sector.

7. The balance of incentives provided to the trading sector must also be changed. At present many of these are directed at fixed asset investment. Financial institutions are capable of financing a much greater proportion of such investment. The Irish economy will grow faster only if new products are developed and sold on new markets. The development of new products and the research necessary to identify opportunities on foreign markets is extraordinarily risky. It is an activity which it is prudent to finance only from equity or risk capital. We believe that state aid to the trading sector should be switched away from fixed assets towards market and product development. We see no reason why the state should not receive royalties on successful investments in these areas.

The Role of Incentives

8. The level and pattern of economic activity is affected much more by the general economic policy of the government than by any set of specific measures labelled 'incentives'. Government decisions about public expenditure, the overall level of taxation, money supply, interest rates, the pricing policies of state-sponsored bodies, incomes policy and the exchange rate have more fundamental effects on economic growth than any tax or other incentives which may be provided. If general economic policies create a climate that is unfavourable to economic expansion, incentives to compensate cannot provide a long-term solution. The double distortion created merely delays efforts to solve the underlying problems.

9. The same applies to a whole range of more specific government policies. This includes the policies relating to energy, transport, industrial relations and employment protection. In recent years, these specific policies have raised costs and reduced competitiveness. With the resources available in Ireland, it is not possible to provide incentives which would offset the adverse effects of these policies. Any attempt to continue on the present course, while mitigating its worst effects by providing selective incentives, is unlikely to succeed.

10. We conclude that the provision of incentives has a limited role to play in accelerating economic growth in Ireland compared with what can be achieved by adopting general economic policies and specific sectoral policies

that are favourable to growth. A stable and favourable economic environment, which includes a good tax system, will prove more attractive to Irish and foreign investors and to their employees than the existing hostile environment mitigated by numerous incentives.

11. In this report we examine existing and some possible new incentives. In most cases we recommend that these be removed or not introduced if they do not exist already. This should not be interpreted as implying that we are unsympathetic to the activities which such incentives would encourage. In considering the introduction of an incentive, it is not sufficient to show that the activity at which the incentive is directed is worthy and would benefit. If this criterion were accepted to justify incentives, virtually all items would qualify for incentives. This is because there is almost no activity which cannot be shown to benefit from a selective reduction in taxation. Taxation is a real cost to be borne by the community for the provision of public services which the people are thought to value. If one activity is relieved of its share of taxation, then other sectors must bear a correspondingly higher share, or public services must be reduced. In considering the introduction of incentives for one sector, account must be taken of the disincentive effects on other sectors which bear the cost. Incentives must be provided on a limited basis for priority areas.

12. We have not examined in detail all the incentives which it is possible to devise. It would not be possible to do so, given the very large number of such schemes that have been proposed at one time or another. We see that tax incentives have a limited role to play and must be concentrated on key areas. We would, therefore, reject the vast majority of proposals for new tax incentives.

Existing Incentives

13. We have been unable to ascertain any coherent policy in relation to the granting of incentives in the past. Often they have been introduced to offset shortcomings in other areas of economic management, leaving the enterprise sector no better off. Many were introduced on an *ad hoc* basis and no regular review of their effectiveness is carried out. The result is a vast array of provisions, described as incentives, for all sorts of different activities so that investment and economic activity is now much more influenced by considerations of 'tax efficiency' rather than economic or commercial benefit.

Justification for Incentives

14. We have concluded that incentives are justified only on very limited grounds.

- **Firstly**, there are cases where the market clearly fails to bring about the desired allocation of resources. These include the 'infant industry' case.
- **Secondly**, in order to accelerate the growth in national income, incentives may be required to match those offered in competing countries in order to attract desirable internationally mobile capital investment.
- **Finally**, incentives may be required to offset shortcomings in other policy areas. One particular difficulty encountered is the effect on the exposed market sector of exchange rate policy developments which are inconsistent with the market conditions being experienced by traders in that sector. These are second-best but necessary solutions. It is preferable that the exchange rate is fixed at a level which promotes the development of the exposed sector.

Form of Incentives

15. We have examined the main forms of intervention open to government to alter market sector decisions. Though there is no definitive argument for or against tax-based incentives, we have concluded that direct aids are more likely to be cost-effective than tax reliefs. They also have the merit of greater flexibility and can be applied more selectively.

SUMMARY OF RECOMMENDATIONS

Introduction

Many of the provisions described as incentives in the existing code are needed merely to deal with the distortions which arise from the present system. The proposals in our first report would remove these distortions and render many existing incentives redundant. Therefore, we stress that the following recommendations with the exception of recommendation No. 30 are valid only in the context of the general scheme of taxation in our first report.

FULL RECOMMENDATIONS

Our full recommendations are:

Chapter 6: Tax Reliefs Applied to Profits

1. Commitments given under export sales relief, Shannon relief and the relief of manufacturing profits, whether these are enforceable contractual obligations or not, cannot be repudiated without causing serious damage to Ireland's reputation as a suitable location for foreign investment. There is no alternative to honouring these commitments.

2. Once the present special relief for manufacturing profits expires, such profits should be charged to tax at the same single rate which applies to other income.

3. Co-operative societies should operate under the same taxation arrangements as other businesses.

4. Income from stallion fees should be relieved from tax to whatever extent is necessary to ensure the continued development of the industry in Ireland.

5. Income from woodlands should be subject to the same tax treatment as income from other sources. Losses, which are at present disallowed, should be allowed against other income.

6. Capital allowances in respect of both new and second-hand machinery and plant should be provided on an indexed basis to write off the cost of the asset to its residual value over its estimated useful life. Residual values and estimated useful lives of assets should be set down in regulations, following consultations between the Revenue Commissioners and the relevant professional bodies.

7. Capital allowances on lorries and motor vehicles should be given on an indexed basis at a rate sufficient to write off the cost of the assets to their residual values over their estimated useful lives.

8. The present industrial buildings allowance should be withdrawn and replaced by normal depreciation on an indexed basis.

9. Accelerated capital allowances in respect of hotel buildings should be withdrawn and replaced by normal depreciation on an indexed basis.

10. The farm buildings allowance should be abolished and the expenditure on farm buildings treated in the same way as industrial buildings.

11. The investment allowance in respect of expenditure on new ships should not be restored. Ships should qualify for capital allowances on the same basis as other plant and machinery.

12. Accelerated capital allowances in respect of multi-storey car parks should be withdrawn and such buildings treated in the same way as other commercial buildings.

13. Capital allowances should be provided on an indexed basis for toll roads and bridges, so as to write off the cost of the assets over the period of the agreement between the providers of such facilities and local authorities.

14. Allowances for expenditure on dredging should be sufficient to write off the cost of a dredging operation (on an indexed basis) over its estimated life.

15. Expenditure on research and development should be allowed as a deduction in computing trading income for tax purposes, whether or not related to the trade.

16. Expenditure on the acquisition of patent rights should be allowed in equal annual instalments (on an indexed basis) over the life of the patent.

17. The exemption from tax of certain patent income should be ended.

18. The allowance in respect of expenditure incurred on the construction of moderate cost rented residential accommodation should be discontinued and such accommodation treated in the same way as other rented residential accommodation.

19. A depletion allowance should be granted (on an indexed basis) which would write off the cost of a quarry to its residual value over its estimated useful life. The allowance could, at the option of the taxpayer, be given either on a straight-line basis or by reference to the rate of extraction.

20. Capital allowances in respect of plant and machinery should in future only be given by reference to the net cost to the promoter, after taking account of any grants received.

21. Capital allowances should not be given in respect of assets which are not in use for the purposes of a trade or profession. Initial allowances given on the basis of expenditure being incurred should be discontinued.

Chapter 8: Incentives and Employment

22. The relief granted to companies which increase employment should be phased out in line with reductions in employers' social insurance contributions.

23. Deductions in computing profits for tax purposes in respect of wages and salaries should be net of amounts received under employment schemes.

Chapter 9: Miscellaneous Incentives

24. Apart from the changes recommended earlier in this report, we see no reason to restrict leasing or to deny capital allowances to lessors.

25. Refunds should not be made of advance corporation tax where the company has insufficient liability against which to set the advance corporation tax paid.

26. Legislation should be introduced to stop the use of artificial preference share mechanisms and the use of section 84 of the Corporation Tax Act, 1976 to provide loans at special rates.

27. Future schemes providing interest relief to farmers should be given directly rather than tax based.

28. When banks and building societies are charged to tax at the same rate of tax, the special tax concession to approved banks on their housing loan operations should be withdrawn.

29. Employees should be charged to income tax at the date of disposal on the full amount of the proceeds of disposal of shares issued to them free of charge under profit sharing schemes. In cases where the shares were acquired at less than market value, the employees should be charged to income tax on the difference between the proceeds of sale and the cost at acquisition indexed to consumer prices up to the date of disposal.

Chapter 10: New Incentives and Disincentives

30. In relation to the taxation of foreign earnings

(a) where the period of foreign employment does not extend over a full tax year, the earnings should be taxed in the normal way, that is, on the basis of income arising,

(b) where the period of foreign employment extends over a full tax year, the individual's residence status for each tax year or part of a tax year in the period should be determined by factors other than the 'place of abode' test, and

(i) if he is non-resident but for the 'place of abode' test, the foreign earnings should be ignored

(ii) if he is resident on this basis, the foreign earnings should be taxed in the normal way, subject to a deduction for reasonable additional expenses incurred in living abroad.

Chapter 11: Implementation

31. In making the transition from free depreciation to normal depreciation on an indexed basis, normal depreciation on an indexed basis should be extended to existing assets on the basis of their written down values, assuming normal depreciation.

32. All existing companies with entitlements under the legislation providing for export sales relief, Shannon relief or the reduced rate of tax on manufacturing profits should be entitled to opt for either the old or new tax systems until the expiry of the relevant relief. If they opted for the old system, they would pay tax at the relieved rate but the employers' social insurance contribution would continue to be chargeable on the basis of payroll.

33. Profits chargeable to tax at the reduced rate applying to manufacturing profits should carry the full imputation of tax borne at the company level when these are distributed to shareholders.

34. Companies should be required to deduct sufficient extra tax on dividends paid out of profits which have borne the reduced rate of tax on manufacturing profits, so that Irish resident shareholders liable to tax at the single rate would have their tax liability on such income satisfied in full.

35. When advance corporation tax is fully operative so that tax credits are fully matched by corporation tax actually paid, the concept of the primary fund, which is established under the legislation providing for a reduced rate of tax on manufacturing profits, should be removed.

GLOSSARY OF TERMS

Accelerated Depreciation:	Writing off the cost of assets before the normal useful life of the assets, that is at higher depreciation rates than normal.
Advance Corporation Tax (ACT):	Tax paid on the occasion of a dividend etc. ACT is set against the company's tax liability on its income. Income in this context excludes capital gains.
Capital Allowances:	Tax allowances for expenditure on specified categories of capital assets.
Cash Flow:	The flow of money payments to or from a business.
Compliance Costs:	The costs in money, time and effort of assessment and collection of tax borne by the private sector.
Debt Finance:	That part of a company's capital provided by lenders.
Depreciation:	The reduction in the value of an asset through wear and tear.
Dividend:	The amount of a company's profits that the board of directors decides to distribute to shareholders.
Efficiency:	Allocating economic resources so that optimal output is achieved.

Effective Tax Incidence:	Who ultimately pays a tax as a result of adjustments to economic behaviour after the tax is legally assessed.
Equity Finance:	That part of a company's capital provided by the ordinary shareholders.
Equity, Tax:	Standards of fairness. The tax payable should accord with ability to pay.
Fixed Assets:	Those business assets which are purchased for continued use in production (e.g. land, plant and machinery, buildings).
Formal Tax Incidence:	The point where a tax is legally assessed. For example, the formal incidence of personal income tax is personal income.
Free Depreciation:	Writing off as much of the cost of an asset in a single year, usually the year of purchase, as the claimant wishes.
Gearing:	The relationship between a firm's capital indebtedness and its equity capital (capital gearing) and the relationship between interest charges and available earnings (income gearing).
Gross Investment:	All expenditure on investment.
Imputation System:	A system under which part of the corporation tax paid by a company is treated as satisfying income tax payable by the shareholder.
Incentive:	An inducement designed to promote a particular activity.
Indexation:	Linking the tax structure to movements in an index of prices.
Inflation:	A process of rising prices resulting in diminishing purchasing power of a given nominal sum of money.

Initial Allowances:	A tax reduction for certain kinds of investment given in the year of expenditure whether or not the asset is in use.
Investment Allowances:	A tax deduction which may be restricted to investment in certain areas or certain assets. This allowance increases the depreciation base of an asset so that allowances in excess of the cost of the asset may be granted.
Marginal Tax Rate:	Rate of tax paid on the last pound of additional income or capital.
Net Investment:	Total expenditure on investment minus depreciation.
Neutral Tax System:	A system which does not distort economic behaviour.
Primary Fund:	A notional fund established under corporation tax legislation consisting of the amount of a manufacturing company's profits actually taxed at the reduced rate of corporation tax, less that reduced tax, together with dividends received by that company which carry the reduced tax credit.
Rate of Return:	A ratio used to measure the efficiency of an investment. It is calculated by expressing net profit after depreciation as a percentage of the capital used.
Saving, Flow of:	The increase in the stock of savings in any given period.
Savings, Stock of:	The existing pool of resources comprising all past savings.
Share Capital:	The total amount of shares issued by a company.
Sheltered Sector:	Part of the market sector of the economy consisting of firms and businesses which do not export and do not have to meet competition from imports in the home market.

Taxation:	Compulsory levies imposed by governments which divert resources from chiefly private sector activities to publicly provided goods and services.
Tax Avoidance:	Arranging one's financial affairs within the law so as to minimise taxation liabilities.
Tax Base:	The object to which the tax rate is to be applied, e.g. income, wealth or consumption.
Tax Credit:	An offset against tax liability.
Tax Incentive:	A provision in the tax code which is designed to promote a particular activity.
Tax-related Lending:	A type of finance which enables the borrower to benefit from certain tax incentives.
Unsheltered Sector:	That part of the market sector of the economy which is exporting and/or which has to face competition from imports in the home market.
Value-added:	The income generated by any business undertaking representing the total sales value of its output, less the cost of materials and services bought in and less depreciation. It is a measure of the value which a business has 'added' to the materials and services bought in for its process of production.
Venture Capital:	Private investment in small, new, unproven and high risk companies.
Working Capital:	The aggregate of stock plus trade debtors less trade creditors insofar as they arise from the day-to-day operating activities of the business.

Part I

General Principles

CHAPTER 1

DEVELOPMENT OF THE NATIONAL ECONOMY

Introduction

1.1 Our terms of reference require us to pay attention to the need to encourage development of the national economy in framing our recommendations. Increasing living standards through higher sustainable rates of growth in national output is the paramount objective of Irish economic policy. While increased living standards will require higher individual productivity and value-added, high sustainable growth will also lead to higher employment.

ECONOMIC OBJECTIVES

Living Standards

1.2 Ireland ranks ninth of ten EEC countries in terms of income per head, with a level of income about half the EEC average. Nonetheless, Irish people aspire to the living standards enjoyed in other EEC countries. An increase in living standards in Ireland depends on increasing the value-added[1] in the goods and services produced here. This can be done by improving productivity in existing activities. It can also be done by shifting resources from activities with low productivity to those with higher productivity. This implies a continual restructuring of the economy from what the Japanese call 'sunset' industries to 'sunrise' industries, which allow

[1]The added value or income generated by any business undertaking is the total sales value of its output, less the cost of materials and services bought in and less depreciation. Part of a company's turnover is the result of the work of people outside the company, namely the raw materials, products and services which the company has purchased from outside. The remainder of a company's turnover is attributable to the efforts of its own work force, the use of its physical assets and the entrepreneurial talent and effort necessary to combine these factors productively. This remainder, after providing for depreciation of capital used in the productive process, is the income created or the value added by the business. Thus, 'added value' represents the economic contribution of any business. The total value added in the economy amounts to national income. It provides the returns to employees and providers of capital.

higher value-added per employee, while maintaining a high level of employment.

1.3 It is only by increasing value-added that the income can be generated to provide higher living standards for those already employed in the business, additional employment opportunities for others, or the tax revenue for government to distribute in the form of public expenditure to fund additional services or employment creation. Therefore, the provision of incentives must concentrate on increasing the amount of value-added in the economy.

Further Constraints

1.4 Economic growth at rates sufficient to meet aspirations for living standards only seems possible in the context of a low rate of inflation, high rates of savings and productive investment and sustainable public finance and balance of payments positions. These are not necessarily desirable aims in themselves but only in so far as they are associated with progress towards the ultimate objective of improving living standards.

1.5 In our first report we distinguished between the sheltered and unsheltered sectors of the economy. Unsheltered or exposed activities are those which are exporting and/or which have to face competition from imports in the home market. Broadly, these consist of the production of goods and services which are traded internationally. Sheltered activities are those which do not export and do not have to meet competition from imports in the home market. For an open economy like Ireland, the key to economic success lies in the growth of the unsheltered sector and pushing back the balance of payments constraint. Economic policy must also be concerned with the efficiency of certain sheltered activities, such as the provision of infrastructure, which are crucial to the competitiveness of the unsheltered sector.

1.6 The public finance constraint requires control of public expenditure and the allocation of greater weight to efficiency of expenditure programmes. It also requires an efficient tax system (such as we have proposed) and industrial incentives which are well directed and cost-effective. These should be concentrated on the unsheltered or trading sector.

Living Standards, Employment and Equity

1.7 The twin targets of full employment and rising living standards are not necessarily fully consistent. Exclusive concentration on employment would not lead to higher sustainable living standards. For instance, employment in the unsheltered sector of the economy could be increased by concentrating on the development of labour-intensive industries in which productivity is low internationally because of the nature of the technology and production processes involved. In this way, relatively large numbers would be employed for a given level of output. Such a strategy would result in a low output per head of population and a low standard of living as a result. Employment could also be maintained in industries in which Irish added value is low by international standards (e.g. certain sectors of the agricultural and clothing industries) if we accepted a correspondingly lower level of earnings. Finally, employment in the sheltered sector could be increased by deliberate overmanning. The result would be lower output per person employed.

1.8 A strategy of concentrating on low value-added, labour-intensive industries in what is now, by world standards, a relatively high-wage economy would involve facing particularly tough competition from low-wage developing economies. It could only succeed if wages were reduced. The acceptance of low levels of productivity to increase employment would damage international competitiveness by increasing costs. Even if an attempt were made to confine such a policy to the sheltered sector, the effects would be felt throughout the economy since the higher costs entailed in such a policy would have to be borne by the unsheltered sector.

1.9 Accepting that the major objective of economic policy is to increase living standards through the growth of output, we consider this can only be done by simultaneously improving productivity and increasing employment.

1.10 A high rate of growth does not necessarily achieve a less unequal distribution of income and wealth. Faster growth is more likely in an environment which is favourable to risk-taking. To encourage risk-taking, incentives may have to be provided which, initially at least, may result in greater inequality. The proposals in our first report achieve greater equity in taxation and facilitate greater risk-taking. If risk-takers succeed, the economic benefits may be distributed fairly widely. In particular, if additional employment is created, the result is likely to be a reduction in inequality.

1.11 It would be easy to exaggerate the potential conflict between achieving higher growth and more equal distribution. In practice, it is much easier to equalise distribution when living standards are increasing. It is also true that the distribution of income has become more unequal in the recession. Higher growth will tend to ease distributional issues. However, if, as some argue, individuals and groups are more concerned with their relative rather than their absolute position, there is no solution to the distributional problem — there is only a never-ending struggle between competing individuals and groups to improve their relative positions. Even if the distribution of existing income and wealth were equal, living standards would still be unacceptably low. Therefore, higher growth is essential.

1.12 Furthermore, many of Ireland's current economic problems such as the high level of unemployment and the imbalance in the public finances will be far easier to resolve if there is sustained growth in national output at a high level. In our view, this leads inevitably to the conclusion that growth in national output is the paramount objective of economic policy. The nation cannot afford to waste or underuse its existing resources — labour, capital, land or enterprise.

1.13 Policy discussion in recent years suggests that the attainment of full employment is a vital objective of economic and social policy. Full employment is desirable because the real living standards of a country are determined by the volume of available resources and by the efficiency with which they are used. Unemployment of labour wastes a most valuable resource and results in a lower standard of living than could otherwise be achieved. Secondly, unemployment widens inequality in the distribution of income. It constitutes a failure to provide equal opportunities for all.

PRESENT ECONOMIC SITUATION

1.14 At the time of writing, Irish society is facing serious economic problems. Growth is slow. Inflation has averaged 16 per cent per year since 1974. The public finances are seriously dependent on foreign borrowing. Unemployment at over 215,000,[2] or over 17 per cent of the labour force, is at unacceptable levels. All the problems suggest an urgent need to improve competitiveness. Unless the rate of growth of output can be raised significantly, it will not be possible to create jobs on the scale sufficient (estimated at about 20,000 a year) to absorb the growing labour force.

Competitiveness

1.15 Most of the goods and many of the services produced in Ireland face competition from overseas suppliers on both the home and export markets. A rise in domestic costs relative to those of competitors tends to result in lower employment than would otherwise be achieved. Where prices are largely determined externally, rising costs reduce profit margins and may force Irish producers out of particular markets and make their entry into new markets more difficult. If an Irish producer increases his prices in line with costs, he is likely to suffer a loss of market share. In either case output and employment will be lower, and, in the longer-run, both the incentive and ability to invest in increased capacity will be impaired. At the same

[2]As at January, 1984.

time, rising relative costs may deter potential foreign industries from locating in Ireland, thus reducing further long-term employment prospects. Conversely, a relative fall in costs will tend to improve profitability, market share, investment and employment. This is not to say that costs are the only factor which influence the level of employment. There are others, including marketing and product development, which are vital to successful exports. However, the level of costs is important. If relative costs are allowed to increase and these are not offset by movements in the exchange rate, higher unemployment is the inevitable result. The higher the relative level of Irish costs the lower is the number of product markets open to Irish producers.

1.16 An important element in competitiveness is the policy to be pursued by government in relation to the nominal exchange rate. Where the Irish pound is overvalued in the sense that costs are too high to be compatible with full employment and a sustainable balance of payments position, the effect is to increase for a time the real disposable income of consumers at the expense of those who may lose their jobs. This is done by artificially depressing the prices of imports. It also reduces company profits in Ireland because domestic producers have to hold down prices to compete with cheaper imports at home and cheap competing products in foreign markets. If industrial policy has to be applied in a situation in which the Irish pound is over-valued, the need for Exchequer support for the exposed market sector is greater. To the extent that the opposite applies, the need for assistance will be correspondingly less.

1.17 The full effects on employment of an improvement in competitiveness would take time to materialise. An improvement in competitiveness would not necessarily lead to a significant improvement in economic prospects in the short-term. A short-term improvement in competitiveness could be achieved by a devaluation of the Irish pound. The immediate effect would be to cut real incomes, while the subsequent build up of net exports, output and employment would run over several years. However, this improvement in competitiveness would be lost if incomes rose in line with the rise in prices which resulted from the devaluation. Devaluation, therefore, would only succeed in so far as it was a mechanism which succeeded in reducing the real wages of those in employment.

1.18 The objective is to reach and maintain levels of costs which prevail in competing countries. Any effective policy must concentrate on domestic costs since these are the only costs subject to domestic control. In the final analysis, domestic costs reflect the income of Irish residents. Cost moderation, therefore, may require income moderation. The alternative is to improve the efficiency with which goods and services are produced. Such improvements in efficiency cannot be reflected fully in income increases for those already in employment if the increase in costs is to be reduced, existing employment maintained and new jobs created. In practice both improvements in efficiency and moderation in costs must be achieved.

Conclusion

1.19 We conclude that the ultimate objective of economic policy is to attain higher living standards. This can only be achieved by policies which generate higher output and employment.

CHAPTER 2

EFFICIENCY EFFECTS OF PROPOSALS IN FIRST REPORT

Introduction

2.1 The recommendations in our first report propose radical changes in our system of taxation which would have profound effects on the economy. We believe that our proposals would increase incentives to work, innovate and develop the Irish economy. Before considering any additional incentives which may be necessary, we recall the improvements in efficiency which would result from the implementation of the recommendations made in our first report.

Defects of Present System

2.2 To appreciate the radical changes involved in adopting a simple and rational system of taxation, it is necessary to acknowledge the perverse way in which the present system influences economic decisions. Our tax system is inefficient and unfair. It is inefficient because it encourages tax avoidance rather than increased output. It is unfair because people who earn their incomes in different ways are taxed to different degrees, even though they have the same income. It is far too complicated. This leads to misunderstandings, increases administrative and compliance costs and inhibits productive effort because of uncertainty about the tax consequences.

2.3 Income from productive effort and risk investment is taxed much more heavily than capital gains. Considerable effort and ingenuity is devoted to tax avoidance at the expense of economically and socially productive enterprise. As a nation we spend far too much of our time ensuring that investment decisions maximise the after-tax return rather than ensuring that they are economically or socially efficient.

2.4 The level of savings in Ireland is inadequate. Penal taxes are imposed on certain forms of saving and borrowing is heavily subsidised. Incentives are provided for people to save through pension funds and insurance policies but not in other ways, with the result that the supply of capital for risk investment is reduced. Incentives are available for people to invest in housing. These are not related to housing needs. As a result too much investment goes into certain types of housing and the price of building land is forced up.

2.5 High marginal tax rates are imposed on earned income at a level which is extremely low by international standards. This makes it very difficult to attract skilled management from abroad to work here and to retain Irish workers with internationally marketable skills. Such marginal rates give a boost to tax evasion.

2.6 In general, the present system of taxation and industrial incentives taxes labour and subsidises capital. Free depreciation, grants and tax-related lending reduce the cost of capital to very low levels. Employment is taxed by the imposition of substantial social insurance contributions. As a result, employers are provided with incentives to replace the factor which is in abundant supply with that which is so scarce that it has to be borrowed from abroad in large amounts. Such a bias in the system is completely contrary to the declared national goal of increasing employment.

EFFECTS OF OUR PROPOSALS

2.7 The recommendations in our first report would promote the development of the economy. This results in particular from the following proposals:

- (i) the uniform treatment of income arising in different forms,
- (ii) the reduction in the rate of income tax made possible by the adoption of a comprehensive tax base,
- (iii) the replacement of social insurance contributions by a social security tax,
- (iv) the removal of the bias in the tax system in favour of borrowings and against savings,
- (v) the systematic adjustment of the tax system for inflation,
- (vi) the uniform treatment of retained and distributed profits of companies and other income,
- (vii) the removal of the bias in favour of debt as opposed to equity finance, and
- (viii) the proposals for taxation of gifts and inheritances.

Capital Gains

2.8 An important defect of the existing system is that ordinary income and realised capital gains are charged to tax at different rates. This encourages switching of income into gains and gains into income, depending on the tax position of the beneficiary. The great reduction in the scope for tax avoidance brought about by implementation of the first report would save much time and effort now expended in attempts to exploit the complexities of the tax system and would free those involved to engage in more productive activities. A lower rate of tax on gains from certain activities may divert resources to those activities away from others with a higher economic or social value. Our recommendations, by charging tax on all income and gains at the same rate, would remove these distortions. In addition, the recommendation that real capital losses should be allowed as an offset to other income should give a boost to much-needed risk investment.

Lower Tax Rate on a Wider Base

2.9 The reduction in the rate of tax and the extension of the tax base, involving as it would the abolition of tax concessions for expenditure on various items, would allow people more control over the spending of their incomes. It would reduce waste because people would be free to spend their income as they thought fit, rather than apply it disproportionately to tax-favoured items. The incentive to evade tax would also be reduced.

2.10 It has been argued that the income tax system induces some workers to claim sickness benefits when they are not actually sick. This is because some claimants of sickness benefit may find themselves better off when they are ill than when they are working because social welfare disability benefits are exempt from income tax. Following the changes made by the Social Welfare Act, 1983, the number of cases in which this arises has been reduced. Our proposal to charge such benefits to tax would further reduce the number of the cases and could be expected to improve work incentives[1]. It would reduce abuses of the social welfare system, leave a greater fund available to those in need and remove any basis for sweeping criticisms which are quite properly resented by those in receipt of benefits to which they are entitled.

2.11 Our proposals involve a reduction in the marginal rate of tax on earnings, while generally maintaining average tax rates. A tax system in which marginal rates of tax are lower for a given average rate has less of a disincentive to work. For this reason we believe that the system we recommend, involving a relatively low tax rate on as wide a base as possible, would improve incentives substantially. It should also significantly reduce the incentives for tax evasion which are closely related to marginal tax rates. A reduction in marginal tax rates also improves the risk/reward ratio.

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[1]G. Hughes, *Social Insurance and Absence from Work in Ireland* ESRI Paper No. 108 January, 1982 p. 64.

2.12 It has been suggested that the very high rates of tax which now apply to income from employment in Ireland make it very difficult to attract top management from international companies to work here and to retain the highest skilled Irish personnel in the country. Our proposals would result in a significant change in this area. Foreign nationals would be encouraged to work in Ireland and would have an opportunity to accumulate significant capital resources while residing here. This would prove an added incentive to perform functions such as research and development in Ireland. Irish people with internationally marketable skills would be encouraged to return or remain here.

Social Security Tax

2.13 We have identified competitiveness as one of the key elements necessary for Irish economic success. In the absence of other tax changes, our proposals for a social security tax[2] would remove a burden of over £600 million which is now exclusively levied on goods and services produced in Ireland. Obviously this sum would have to be raised by alternative means. However, if this is done in the way we envisage there would be a substantial reduction in taxation levied on goods produced in Ireland and an increase in taxation levied on imports. This should result in a significant increase in exports and an increase in the share of the home market taken by Irish goods. The net result would be an increase in employment and an improvement in the balance of payments. The first step towards improving Ireland's economic performance is to stop penalising goods and services produced here.

2.14 In addition to discriminating in general against goods produced in Ireland, social insurance contributions discriminate in particular against labour intensive industries. By taxing one factor of production — labour, as distinct from capital or land or enterprise — they tend to encourage the replacement of labour intensive methods where possible by capital intensive methods of production, particularly in those businesses which cannot shift the burden of social insurance contributions fully to employees. This results in higher unemployment.

2.15 Social insurance contributions also contribute to a bias in the system in favour of providing remuneration in the form of benefits-in-kind such as favourable loans and cars for private use. This is because the provision of such benefits do not count as remuneration for purposes of social insurance contributions.

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[2]This proposal was the subject of a reservation by Mr. Daniel Murphy and Mr. Donal Nevin.

2.16 The distorting effects on employment, the balance of payments and the provision of fringe benefits would be removed by the introduction of a social security tax on the lines recommended in our first report.

Borrowing and Saving

2.17 In our first report we concluded that the overall balance of the tax system in Ireland is heavily weighted towards borrowing and against saving. Two of the major constraints on economic development in Ireland are the level of foreign borrowing and the balance of payments deficit on current account. To the extent that the level of domestic savings can be increased, foreign borrowing and the current deficit can be reduced.

2.18 The recommendations in our first report would significantly improve the climate for savings. In particular, taking account of the effect of inflation on the underlying asset (in the case of saving) or liability (in the case of borrowing) would remove the bias against saving. The removal of the differential treatment of savings, except in the case of retirement savings through approved media, would lead to improvements in economic efficiency arising from increased competition in the financial sector. The replacement of the higher rates of income tax with a direct expenditure tax would also contribute to an improved balance between saving and consumption.

2.19 The existing system makes it very difficult for individuals to accumulate capital out of taxed income. Personal capital resources of a relatively modest amount are often essential if an individual is to be able to set up or expand his own business. Our proposals give a much greater opportunity for individuals to accumulate personal resources. For example, in order to save £10,000 in a year and cover living expenses of £15,000 a married person would have to earn over £58,000 under the present system (at 1983/84 rates of income tax and levies). By comparison under our proposals, given a rate of tax of 30 per cent, he would have to earn £34,500. In order to save £2,000 in a year and cover living expenses of £8,000 a single person would have to earn over £21,000. Under our proposals, he would have to earn £14,000.

Adjustment for Inflation

2.20 In our first report we recommended that the tax system should be systematically adjusted for the effects of inflation. This would involve the indexation of all thresholds, tax bands and tax credits. Indexation does not mean that the government would be committed irrevocably to unchanged income taxes in real terms. It is purely a technical procedure to ensure that consideration of changes in taxation takes, as its starting point, the indexed tax structure. The government would retain full discretion over tax changes. However, any changes would be explicit and shown by reference to the indexed position. More importantly, from the point of view of encouraging economic development, adjusting the tax system for inflation involves taxing as income only what is left after maintaining intact the real value of the capital which generated it.

2.21 The failure to index the income tax system has, at the very least, contributed to the steep increase in the income tax burden. In 1983/84 approximately 40 per cent of taxpayers (about 315,000) are expected to pay tax at rates above the standard rate of 35 per cent. This compares with about 8,000 sur-tax payers or just over one per cent of all income tax payers ten years earlier.

2.22 We believe that a situation in which such a large number of taxpayers is liable to tax at such high marginal rates cannot continue without causing serious economic damage. It has inflationary consequences in that people seek ever larger increases in money incomes in an attempt to maintain their disposable income in real terms. It contributes to tax avoidance through the extension of fringe benefits which are inadequately charged to tax. Tax evasion is given a great boost. The failure to index the system has contributed to this growth in the number of taxpayers liable at the higher rates because Ministers for Finance have invariably treated nominal increases in allowances and bands of taxable income as concessions to taxpayers instead of recognising that the failure to make such increases in reality resulted in a rise in the burden of taxation.

2.23 The existing system does not compensate for the effects of inflation on the tax base in any coherent way. Various measures to do this, in whole or in part, have been introduced on an *ad hoc* basis over the years. This has had harmful economic and social consequences. The systematic adjustment of the system for the effects of inflation would remove the need for these *ad hoc* measures. In particular, the present system of stock relief[3] would be replaced by the cost of sales adjustment proposed in our first report and the existence of accelerated depreciation allowances would be called into question.

2.24 The allowance of a deduction for interest at high nominal rates has given an incentive for companies to become over-borrowed in so far as they obtain a deduction for nominal interest payments which, in reality,

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[3]It is proposed to introduce from 1984 a new system under which permanent relief will apply by reference to price increases only, no account being taken of volume changes. The relief will be limited to one-third of the appropriate price increase. As regards relief under the existing system, clawback of relief deferred last year and any liability to clawback for later accounting periods will be waived, subject to safeguards against abuse. Budget Speech, 25 January, 1984

are repayments of capital. The adoption of an inflation-adjusted tax base would rectify this anomaly by taking account only of real interest payments.

2.25 Since 1978, the existing system endeavours to charge only real capital gains to tax. Income in the form of capital gains is thus the only form of income which is taxed on a real or inflation-adjusted basis. While this treatment is correct, it should apply not only to capital gains. So long as it does there is a bias in the system against the forms of income which are not so treated. To the extent that income from productive effort tends to be charged mainly to income tax and corporation tax, there is a bias against productive effort. As a result of the proposals in our first report this distortion would be removed.

Taxation of Company Income

2.26 The present Irish tax system charges a different amount of tax on income taken out of a company by way of salary or dividend. Retained and distributed profits of companies bear different rates of tax. Efficiency would be best served if the decision to retain or distribute profits were made on the basis of commercial criteria rather than influenced by tax considerations. The system of company taxation which we propose removes many of the distortions arising from the existing system. It would achieve greater neutrality between retained and distributed profits, would avoid the double taxation of dividend income, encourage the development of financial markets and increase the efficiency of investment. The charging of tax at a single rate on all income also makes it possible to achieve neutrality of tax treatment between small companies and unincorporated business with which they may be in competition.

2.27 The present tax system favours debt over equity finance. This is because interest payments are allowed as a deduction for tax purposes while dividends are subject to an element of double taxation. Our recommendations, by removing this bias, would give greater encouragement to equity finance. This has four main advantages. Firstly, equity finance allows firms to undertake long-term planning and development. Secondly, a strong balance sheet provides companies with flexibility by enabling them to increase their borrowing, if necessary. Thirdly, low gearing ensures a company's independence and security. Fourthly, the cost of borrowing may be reduced. A company's gearing affects its credit rating, with a direct effect on the cost of debt finance and some indirect effect on its equity rating.

Taxation of Gifts and Inheritances

2.28 Inducements are necessary to encourage the transfer of productive assets, particularly agricultural land, into the hands of qualified younger people who might be expected to use them more productively and efficiently. We consider that our proposals would have beneficial effects in the following ways:

(i) firstly, making death a disposal for capital gains tax purposes would remove an incentive for an individual to postpone the transfer of his assets until death in order to obtain the benefit of the favourable tax arrangements which now apply only to transfers on death,

(ii) the removal of valuation concessions which apply to productive assets for purposes of taxation of gifts and inheritances should help to reduce the price of these assets, thereby making entry into the industry somewhat easier for individuals who cannot acquire assets by way of gift or inheritance,

(iii) thirdly, the proposal that a tax liability on a gift or inheritance could be payable on an annuity basis would confer a competitive advantage on younger people. This is because for a given inheritance, the annual payment of tax on the annuity basis will be less the younger the recipient. An example is given in paragraph 10.33,

(iv) fourthly, our system would favour savings in an individual's own life-time over inter-generational accumulations. We believe that this would lead to more efficient and productive use of savings.

New Businesses

2.29 It is also worthwhile to draw attention to the benefits of the proposals in our first report for the person setting up a new business venture. He would be at far less of a disadvantage than under present conditions and would be better able to compete with those enjoying the advantage of inherited wealth. He would have been taxed less over the period when he was saving from his wage or salary to start the business. He would be taxed less if he continued to save (most new enterpreneurs plough back a remarkably high proportion of their income into the business). His tax bill would rise only when he started to increase his spending on consumption.

Simplicity

2.30 In addition to these advantages, major benefits would flow from the increased simplicity of the system we propose. Simplicity in a tax system is achieved if the administrative costs of tax collection are small and if the compliance costs for the taxpayer in terms of money, time and mental effort are also small. In particular, uncertainty about the tax implications of a business transaction may result in delay, cancellation or the costs of consultation with tax experts. We received ample evidence in submissions that the existing system is perceived by the taxpayer to be incomprehensible. The very complexity of the present tax system deters many from undertaking ventures which would benefit both themselves and the country as a whole.

2.31 Under our proposals, all income would be taxed at the same rate. This can be clearly understood by taxpayers who would be better able to assess the impact of such a system on their actions. The integration of income tax and social security tax would reduce compliance costs (particularly for small businesses) and would give people more time to attend to developing their own business rather than worrying about complying with their tax obligations and those of their employees. The collection of PAYE would be a simple and straightforward matter with no need for end of year reviews, save in exceptional cases.

Conclusion

2.32 In so far as individuals when left to their own devices will make the right decisions, it is wasteful and cumbersome to have a tax system which unduly influences individual or business choices. The requirement of neutrality in a tax system means that it should not interfere with the relative rewards of the different types of work between which an individual must choose, the relative attractions of work and leisure and the relative returns from different types of investment. That is not to say that neutrality is a principle which must be applied absolutely; merely that departures from it need to be specifically justified and made in a coherent context. The present tax system is so incoherent that it distorts individual and business choices in many ways which are contrary to the economic and social interests of the country as a whole. By moving much closer to neutrality in taxation, we consider that our proposals would lead to an increase in efficiency. This would come about through

(i) a switch in the balance between borrowing and saving in favour of the latter,

(ii) a reduction in the balance of payments deficit on current account,

(iii) an increase in the level of output arising from greater competition,

(iv) a higher level of employment, and

(v) an increase in the efficiency of investment.

CHAPTER 3

THE NEED FOR INCENTIVES

Introduction

3.1 In Chapter 2 we outlined the economic benefits which we see resulting from the implementation of the general system of taxation proposed in our first report. A necessary complement to these broad reforms is a reduction in the large number of special reliefs in the present code which have added to the distortions and complexity of the present system. Here we consider the justification for departures from our general system by way of incentives or disincentives. The historical development of the incentives provided in the existing code is set out in Appendix 2.

Definition

3.2 We define a tax incentive as a provision in the tax code which is designed to promote a particular activity.

Market Imperfections

3.3 Taxation should not interfere with the allocation of resources brought about by the market except in instances in which the market fails. There are many imperfections in the market. Lack of information about market conditions or inaccurate expectations about future conditions may lead to waste. The existence of economies of large scale production may mean that small changes are unattractive and that highly organised large structural changes are necessary to improve efficiency. Monopolistic restrictions by large productive concerns or by groups of workers may impede change. Certain social costs (or benefits) resulting from an economic activity may not be taken into account by private individuals. Individuals may fail owing to inertia to respond to market pressures.

3.4 In a number of these cases, the best form of corrective action lies in measures other than fiscal incentives, for example, through retraining, state enterprise, wage or price regulation and control of monopoly powers.

However, in some cases fiscal incentives or disincentives may be appropriate to counteract the effects of market imperfections.

3.5 A further argument in favour of incentives is to provide protection for infant industries. This is based on the fact that unrestricted free trade may be undesirable because some industries may need time to reach maturity or grow to sufficient size to compete with longer established industries in other countries. There are some difficulties in selecting appropriate cases in which the argument applies. Firstly, insulating such industries from the full effects of competition may mean that they will never reach maturity. Secondly, it is difficult to know when the aid should be withdrawn. Despite the problems, we believe that aids to protect infant industries may be necessary.

Higher Irish Costs

3.6 Unavoidable costs are imposed on certain activities carried on in Ireland due to the country's peripheral location in relation to our major markets. For example, it is apparent that a producer on the European mainland has lower transport costs than an Irish producer competing in EEC markets. In this case assuming both producers are equally efficient, the Irish producers will not be competitive.

3.7 This lack of competitiveness may be offset in a number of ways. Firstly, there may be a transfer of funds from outside Ireland, for example from the EEC Regional Fund. Secondly, competitiveness may be improved by lower costs in Ireland, for example, lower wage levels. Thirdly, the Irish producer may increase his efficiency. This may be done by improving productivity, thereby reducing unit costs of production. Fourthly, the lack of competitiveness may be offset by a grant or similar payment to the Irish producer. Such a grant would have to be financed by the general taxpayer. If the taxpayer does not shift the burden of this additional tax his living standards are reduced. Finally, competitiveness may be achieved by a depreciation in the exchange rate without a compensating adjustment in incomes. Whatever mechanism is adopted to offset the unavoidable costs imposed as a result of Ireland's peripheral location, in the absence of aids from outside sources or greater efficiency, these costs must be reflected in lower living standards in Ireland. Therefore, peripheral location is not an argument for providing incentives.

3.8 Some costs are imposed on activities carried on in Ireland which could be avoided. For example, these include the costs imposed by inadequate road and telecommunications services and uncompetitive electricity prices. It is not appropriate that these disadvantages should be offset by aids designed to compensate. The correct course is to devote whatever resources are available to deal with the underlying problems. Other measures are merely palliative and can be justified only while the underlying problems are being tackled.

Attracting Foreign Capital

3.9 Ireland must continue to attract foreign capital and enterprise from abroad. Foreign firms bring access to markets and modern technology. Their establishment may also allow subsidiary activities to develop. However, experience shows that this will not occur automatically. Incentives will continue to be necessary to counteract strong competition from other countries for internationally mobile projects. The level of incentives provided must have regard to what is being offered in competing countries and the desirability of the projects to Ireland.

Small Domestic Market

3.10 A further possible justification for the provision of incentives in Ireland is the fact that the domestic market is small. Thus, many Irish firms may sell only a small proportion of their total output on the home market. This increases the risk of such firms compared with those operating in other countries where the domestic market is much larger. Such firms are particularly vulnerable to an adverse movement in currency values because their costs are incurred in Irish pounds while so much of their revenues are earned in foreign currency. The question arises whether or not it is appropriate that the higher risk arising from this factor should be offset by a permanent incentive to increase the rate of return.

3.11 In the short-term two points arise. Firstly, there is always some probability that movements in costs and exchange rates will be favourable. It should not be assumed on the basis of recent experience that this would always be remote. Secondly, it would seem that the forward foreign exchange market should be used to cover against exchange risks. On this basis, we do not see a good case for incentives to compensate for the possibility of adverse movements in exchange rates in the short-term.

3.12 In the medium to long-term the argument is more finely balanced. Government may resist exchange rate movements over quite long periods which are in line with economic realities. If this happens, Irish firms in the exposed market sector may be squeezed by costs in Ireland rising faster than revenues in foreign markets. We consider that exchange rate policy should be geared to the needs of the exposed market sector. However, if it is not, some compensating measures will have to be provided if viable and competitive firms are not to be forced out of business with consequent loss of employment.

Conclusion

3.13 We conclude that incentives are justified only on very limited grounds.

- Firstly, there are cases where the market clearly fails to bring about the desired allocation of resources. These include the infant industry case.
- Secondly, in order to accelerate the growth in national income, incentives may be required to match those offered in competing countries in order to attract desirable internationally mobile capital investment.
- Finally, incentives may be required to offset shortcomings in other policy areas. One particular difficulty encountered is the effect on the exposed market sector of exchange rate developments which are inconsistent with the market conditions being experienced by traders in that sector. These are second-best but necessary solutions. It is preferable that the exchange rate is fixed at a level with promotes the development of the exposed sector.

CHAPTER 4

INCIDENCE OF INCENTIVES

Introduction

4.1 In this chapter we examine the incidence of incentives. Incidence is a source of difficulty since incentives do not necessarily have the effect which their formal description implies. Over time they can lose their effectiveness as they are capitalised in asset prices or they are offset by changes in pay or profit margins.

Incidence

4.2 The formal incidence of taxation is the point at which a tax is legally assessed. This may differ from its effective incidence, which reflects who ultimately pays the tax, following the changes in economic behaviour which occur after the tax is legally assessed. Similarly, we may distinguish between the formal and effective incidence of an incentive. For example, the formal incidence of tax relief on company profits is an increase in post-tax profits attributable to shareholders. Effective incidence reflects who ultimately benefits from the incentive: the benefit of tax relief on company profits could accrue to employees in increased pay, to shareholders in higher dividends, to customers in lower prices or to suppliers in the form of higher prices.

4.3 The incidence of an incentive is likely to vary with the type of incentive provided and whether the activity is in the sheltered or unsheltered sector of the economy.

4.4 In the rest of this chapter we consider the likely incidence of the main types of tax incentives which are provided in the present tax code, namely:

(i) incentives for new investment such as accelerated depreciation allowances, or grants in respect of capital equipment, and mortgage relief for new houses,

(ii) tax relief related to the acquisition and ownership of existing assets. Examples are mortgage interest relief on second-hand houses, relief for productive assets from capital acquisitions tax and roll-over relief for capital gains tax purposes,

(iii) relief of profits from certain activities such as the reduced rate of tax on manufacturing profits and the exemption of stallion fees and profits from woodlands,

(iv) other incentives which reduce the cost of capital such as tax-related lending,[1]

(v) personal income tax relief for certain expenditures. An example is the relief in respect of medical insurance premiums, and

(vi) personal income tax relief for certain forms of saving such as life insurance policies.

Incentives for New Investment

4.5 Efficient markets tend to equalise the rate of return at the margin to all forms of investment. Differences in the actual rate of return may continue to exist but these are attributable to differences in the degree of risk. The higher the risk, the higher the premium required if the investment is to be undertaken.

4.6 An investment will be attractive if the promoter believes that he can earn a return in excess of the cost of funds and the return on alternative investments. This assumes he can finance the investment out of his own resources or persuade others to lend him the money. Tax relief tied to a particular form of investment reduces the cost of funds for that investment. It has two effects. It increases (at the expense of the taxpayer) the profitability of investments which would be undertaken in any event. It also leads to investments which would otherwise have been rejected as not sufficiently profitable. The net effect is to direct resources towards the sector where the incentive is in operation. The additional resources may be retained or appropriated by the persons involved in the activity (owners, workers or consumers) or they may be invested to substitute capital equipment for employment, or they may be invested in expansion of productive capacity.

4.7 The granting of an investment incentive is likely to raise productivity and improve the competitive position of the unsheltered sector. This may enable that sector to defend or increase its share of markets, resulting in a higher level of income, employment and production and an improved balance of payments position. Alternatively, the ability of the unsheltered sector to absorb rises in relative costs is increased. There may thus be a tendency over time for the incentive to be bargained away in the form of

[1]See Chapter 10.

cost increases, in the same way as the protective effect of a tariff may contribute to inefficiency.

4.8 The granting of an investment incentive to the sheltered sector increases the profits in that sector in the first instance. This may lead to income increases being demanded and part of the benefit may accrue to employees in that sector. In any event the incentive results in a transfer of income from the general taxpayer to those involved in the sheltered sector. Resources are diverted to that sector which could be used to better effect elsewhere.

Incentives for Investment in Existing Assets

4.9 Tax reliefs may be granted to persons on the acquisition of assets which are already in existence. In these circumstances, the expenditure involved does not necessarily increase the productive capacity of the economy. It may do so if a change of ownership of the assets leads to an improvement in the way they are managed. Incentives provided in this area may be expected to increase the relative prices of the assets in question so as to equalise the rate of return with that available on other assets. In these circumstances, the value of the incentive is captured in windfall gains by holders of existing assets. To have any lasting effect, the incentives provided would have to be continuously improved.

Relief of Profits

4.10 The granting of tax relief on profits operates in the same way as an investment incentive, except that it does so by increasing the rate of return rather than by reducing the cost of funds. The analysis of incidence is the same as in the case of investment incentives, except that there will not be the same incentive to substitute capital for labour and a tax relief on profits will not be confined to expansion of existing activities. In these circumstances, there is a transfer of resources from the general taxpayer to the persons engaged in the favoured activities and windfall gains may accrue to existing operators.

Tax-related Lending

4.11 Tax-related lending operates in situations in which tax incentives available to lenders are used to provide low-cost finance to borrowers. In our first report we concluded that banks pass on almost all of the tax savings arising from tax-related lending to borrowers. However, tax-related lending is not confined to banks or even to financial institutions. It also takes place in the corporate and personal sectors. It is reasonable to assume that at least part of the benefit of such lending accrues to lenders in the form of higher returns. To the extent that the tax savings are passed on to borrowers, the incidence would be as set out in the discussion of investment incentives, that is, helpful in the export sector but a mere distortion in the sheltered sector. To the extent that it is not passed on, lenders benefit from higher returns.

Relief for Personal Expenditures

4.12. If personal tax relief is provided for income spent in a particular way, expenditure on that activity will tend to be higher than it would have been otherwise. Unless the relief compensates for market imperfections, there will be a waste of resources. The benefit of the tax relief may be partly transferred to the suppliers of the service. For example, it is conceivable that part of the benefit of relief for medical insurance premiums accrues to doctors while that of relief in respect of expenditure on a residence may have accrued to the construction industry.

Incentives for Personal Saving

4.13 In our first report we considered the effects of differential exemptions or incentives on savings behaviour. In doing so we distinguished between the stock of savings and the flow of saving. The stock of savings is the existing pool of resources comprising all past savings. This is vast compared with the flow of saving, which represents the increase in the stock of savings in any given period. A tax subsidy on one form of saving would make that form of saving relatively attractive. The working of the capital market would result in a reallocation of resources up to the point where all rates of return are equalised once more at the margin. Once this happens, the tax concession is capitalised in the price of the asset and forms an integral part of the return of the form of saving which it is desired to encourage. There is some loss of economic efficiency, corresponding to the resources which are put to less productive use. This loss persists for as long as the preferential tax treatment exists.

4.14 When the adjustment to the existing stock of savings is completed, the tax subsidy has no effect on the flow of saving. These will be distributed according to the rates of return to be obtained on the market and will depend on the productive potential of alternative forms of investment. A lasting effect on the flow of saving requires not merely the introduction of tax subsidies, but their continuous improvement. We conclude that differential tax subsidies on savings are economically inefficient but the inefficiency is confined to the allocation of existing resources and does not affect the efficient allocation of future savings.

Conclusion

4.15 In general, we conclude that incentives provided for activities solely in the sheltered sector are wasteful. As regards the unsheltered sector, incentives provided increase the ability of that sector to absorb increases in costs from the rest of the economy, or to expand its output and employment. Even in the case of the unsheltered sector, there may be leakage of the benefits to other groups or sectors and the impact of the incentive may diminish.

CHAPTER 5

ALTERNATIVE METHODS OF IMPROVING EFFICIENCY

Introduction

5.1 In this chapter we examine the criteria that incentives should satisfy and compare the use of fiscal incentives as a means of increasing economic efficiency in relation to other methods available to government. We consider the main forms of tax incentives and deal with the arguments in favour of systems based mainly on direct aids and those based primarily on tax reliefs. We also look at the procedures for evaluating the effectiveness of incentives.

CRITERIA

5.2 We believe that any incentives provided should be efficient, simple, credible and comply with our international obligations. We explore the implications of these criteria in the following paragraphs.

Efficiency

5.3 Efficient incentives should be designed to achieve specific results and examined to see to what extent they are achieving their objective. They should also be flexible so that they may be tailored to individual circumstances. Such flexibility is essential if payments are not to be made in cases in which the particular activity would take place in any event. Flexibility implies selectivity. A balance must be struck between the costs arising from additional bureaucracy needed to provide incentives selectively and the waste of resources that arises if they are given universally. It is also desirable that incentives be neutral with respect to the form of business organisation adopted.

5.4 In order to be efficient, the number of incentives provided must be strictly limited to the encouragement of activities which have a high national priority. They cannot be used to encourage all desirable activities. This cannot be over-emphasised. The provision of an incentive increases the amount of resources devoted to the favoured activity by increasing the relative rewards from that activity. It follows that the provision of an incentive for additional activities dilutes the effectiveness of each existing incentive. If incentives are provided for every activity, none benefits; but the administrative complexities increase and overall efficiency suffers.

5.5 The advantages of a selective approach are that, provided there is a successful centralised policy of choosing individual projects or sectors on which state aid is to be concentrated, the returns to the state per pound invested are likely to be high. However, there are dangers with this approach. The problem is how the decisions are to be made about who or what is to be aided. The dangers associated with project selection by government or its agents are:

(i) public sector assessment of future developments may lack the diversity of a myriad of private investment decisions. If the consensus view is wrong, the costs can be very high,

(ii) government selection may allow political pressures to influence commercial considerations in decision-making, and

(iii) having made a wrong decision, governments may be less able to abandon a specific project than private enterprise.

5.6 On balance we favour the publication of the criteria by which eligibility for and the amount of state financial assistance will be determined. All firms should be free to submit their expansion and development plans and those which meet the stated criteria and which are judged to assist in meeting the national objectives should be aided. Selectivity should be exercised as far as possible by making the criteria for aid more selective, rather than by attempting to pick winners in a way which must be arbitrary given future uncertainties — no matter how well informed the decision makers.

Simplicity

5.7 If incentives are to be effective they must be as simple as possible. This means that they need to be transparent so that the potential benefits to the recipients and the costs to the taxpayer are easily assessable. They should also be relatively easy to administer and not impose unnecessary compliance costs on the recipient. It is also desirable that incentives are introduced for defined periods, thus removing a source of uncertainty in the planning of investment and business generally.

Credibility

5.8 There is also a need for continuity in the provision of incentives. It may take many years to convince industrialists that the incentives provided will remain in place despite the inevitable pressures that are applied to change them. Credibility in this area is extremely important. It is hard to win and can be lost overnight. This is a particularly important consideration in Ireland's dealings with foreign investors. Ireland has built up a good name over several decades and we must retain this reputation. The challenge is to retain the confidence of foreign investors in the stability of Ireland as a place for investment, while adapting the incentives which are offered to the changing needs of the Irish economy.

International Constraints

5.9 Constraints are also imposed by Ireland's international obligations. These arise from general obligations undertaken with membership of international organisations of broad scope such as the General Agreement on Tariffs and Trade (GATT) and the OECD. More specific obligations arise from Ireland's membership of the European Economic Community (EEC). These are discussed in Appendix 4.

TYPES OF TAX INCENTIVES

5.10 In this section we first describe, then analyse the merits of the main types of tax incentives, namely:

(i) exemptions or reductions in certain taxes,

(ii) accelerated depreciation allowances in respect of certain types of investment,

(iii) special allowances or deductions designed to promote expenditure on certain preferred activities, and

(iv) tax credits which are either linked to investment or the achievement of specific performance standards.

Tax Exemptions

5.11 Tax exemptions or 'tax holidays' have had an important place in Irish economic development. Ireland has had export sales relief since 1956 and the special reduced rate of tax on manufacturing profits since 1981. Such exemptions are now common in developing economies. They take a variety of forms and vary with investment criteria laid down in the tax legislation. The period and extent of the exemption — whether 100 per cent or something less — may vary with the nature of the business, with the size of the investment and the region of the country, with the size of employment, or with the domestic added value content of the business.

Special Depreciation Allowances

5.12 The Irish tax code also provides for tax relief by way of allowing accelerated depreciation of fixed assets. Such reliefs exist in many countries. The most common schemes are the following:

(i) *Full depreciation* for fixed assets in the year of acquisition.

(ii) *Accelerated depreciation,* i.e. a fast writing off of fixed assets by way of allowing high depreciation rates in initial years and lower than normal depreciation in later years. The overall effect ensures that the depreciation base does not exceed 100 per cent. It is often restricted to specific types of assets.

(iii) *Investment Allowance,* i.e. the depreciation base exceeds the acquisition costs of a fixed asset. The allowance is normally given in the form of an initial deduction and is expressed as a specified percentage of the value of the investment. It is also often restricted to certain types of assets or certain locations.

Special Allowances

5.13 Special allowances permit the deduction of a specified percentage of a business expense over and above the actual amount incurred in computing taxable profits. They are usually tied to outlays on selected activities, for example, research and development, and are normally only allowed in the year of the outlay.

Tax Credits

5.14 A tax credit differs from a tax allowance in that it is an offset against tax liability rather than a deduction from taxable income. However, a tax credit is a more flexible incentive instrument than a tax allowance. Whereas the allowance is essentially an expenditure-linked device, the credit can be linked to either expenditure or the achievement of a performance standard. The credit may be refunded in the case of businesses whose taxes are insufficient to allow the credit to be fully offset against tax due.

EVALUATION OF MAIN TAX INCENTIVES

5.15 Tax holidays are neutral as between capital-intensive and labour-intensive businesses, whereas investment allowances or credits are biased in favour of the former. Tax holidays may, therefore, be more suitable than investment allowances in countries in which capital is scarce and labour is not. Tax holidays are easier to communicate to foreign investors than accelerated depreciation allowances or tax credits. However, they may be wasteful if they are extended to existing activities. It can be difficult to confine them to new activities, due to the need to avoid undermining existing businesses. This problem did not arise with export sales relief. Now that tax holidays must apply equally to home and export sales this is a significant disadvantage.

5.16 Accelerated depreciation reduces the cost of capital. Such an incentive is not appropriate in a country in which capital is in short supply.

5.17 Accelerated depreciation favours investment in long-lived assets. This is so because the benefit from the initial deduction is greater the longer the period over which the assets would have normally been depreciated. The benefit to the taxpayer arises from the once-and-for-all tax deferral which effectively means that funds which would normally have been handed over to the Revenue Commissioners in the early life of the assets are left in the hands of the taxpayer. Effectively, the company receives an interest-free loan from the state, the proceeds of which may be invested at a profit. Accelerated depreciation, therefore, is of considerable benefit[1] to profitable, established and expanding businesses which undertake a programme of acquisition and replacement of assets. Indeed a rapidly expanding business may benefit from accelerated depreciation to such an extent that it may be able to postpone tax payments indefinitely. An investment allowance avoids discrimination by length of asset life. This offers an initial deduction but without prejudice to normal depreciation in the later years of an asset's life. Investment tax credits can also be designed to give the same effect as a special depreciation allowance.

5.18 A disadvantage of tax exemptions and allowances is that they lack transparency. As a result, there is a tendency not to subject them to the same level of scrutiny and assessment which is applied to more explicit incentives such as grants. A further drawback of tax reliefs is that it is extremely difficult to tie them to the achievement of specified performance standards.

5.19 Tax credits have one advantage over other tax incentives. If they are refundable, they benefit the industry which is suffering losses which may be temporary. They are also more explicit than other tax incentives.

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[1]This assumes that the real post-tax rate of return is positive.

TAX INCENTIVES VERSUS DIRECT AIDS

5.20 A major issue in the consideration of state aids is whether the incentives provided should be direct aids such as investment grants, interest subsidies or labour subsidies or whether the aids should take the form of tax reliefs.

The Rate of Tax

5.21 The first point to be noted in considering this choice is the importance of the rate of tax. Generally speaking, the higher the normal rate of tax the more powerful a tax incentive. The proposals in our first report established a basic system of taxation which is realistic and is characterised by a single rate of tax at a relatively low rate. Under such a system, the need for and attractiveness of tax incentives would be very much reduced. A low tax rate is, in itself, a powerful incentive.

Balance of Public and Private Risk

5.22 Except in the case of refundable tax credits, tax concessions are only of value to profitable enterprises. To some this is a great advantage in that, by rewarding success, they are likely to divert a greater volume of resources to efficient enterprises. To others this is a defect in a system of tax reliefs. They argue that tax reliefs help those businesses which have no need of aid. To that extent, they are wasteful.

5.23 From the public sector point of view an advantage of tax reliefs over grants is that the authorities can be less concerned about whether or not a new business will prove viable. If incentives are given in the form of grants without adequate security, failures, for whatever reason, will prove costly. Such arguments have some validity if the incentives are confined to new or expanded business activity. This was the case with export sales relief which was a very efficient and attractive tax incentive. Unfortunately, it is no longer possible to confine tax incentives to new business establishments or expansions of existing businesses. This is due to EEC prohibitions on state aids which only apply to exports. The effect of the EEC rules is that any aid must apply equally to the home and export markets. If such aid were confined to major expansions, this could subsidise new firms entering the home market at the expense of existing suppliers. Therefore, for reasons of fair competition, state aids must now be extended to all existing producers in particular sectors, *vide* the reduced rate of tax on manufacturing profits. It is considerably easier to apply direct aids more selectively than tax concessions without causing unfair competition on the domestic market. Therefore, to be as attractive as direct aids to new investment, tax incentives may be more costly.

5.24 All incentives are concerned with improving the relationship between risk and reward. However, there is a clear difference between grants and tax reliefs. Grants reduce the risk to the promoter of an investment by reducing the amount of his personal capital resources which he is required to commit. Tax reliefs on the other hand operate mainly by increasing the returns to the promoter, if his investment is successful. In general, internationally mobile investors have the markets and the capital and are more interested in additional rewards rather than reduced risk. For that reason, they tend to find tax reliefs more attractive. Native-owned Irish industry must develop foreign markets if it is to expand. This is a highly risky business, in that if it fails there are no assets to realise. Such businesses require a reduction in risk rather than an increase in reward to encourage them to engage in expansion.

Attraction for Business

5.25 It is held that tax concessions are more attractive to business people for reasons which cannot be explained by objective considerations. For example, tax-related lending captured the attention of foreign investors. This was a novel scheme which was not generally available in other countries which offered equally valuable direct aids and tax reliefs as were available in Ireland. The extent to which tax incentives are more attractive than equivalent direct aids can never be determined objectively. We merely note that persons who have considerable experience in this area put the view to us very strongly that this is in fact the case. The attraction of tax reliefs may be due partly to the attitudes of businessmen to state intervention. Grants or other direct aids suggest a degree of state intervention, whereas tax reliefs do not.

Transparency and Accountability

5.26 Tax incentives also suffer from a number of disadvantages. Firstly, it is extremely difficult to estimate the benefits arising to the state from tax concessions. The effect on tax revenue cannot always be measured accurately, nor can the results of granting the concessions be estimated with any precision. The absence of a statistical foundation for the granting of concessions is a major defect in their effective use, since it precludes an assessment of the value for money obtained from them. While this problem also applies to some extent in the case of direct aids, these tend to be reviewed, thereby ensuring that there is some check on the value being obtained for the incentive.

5.27 Incentives are rarely tied to the achievement of results — a noted exception to this is export sales reliefs which is related to the *increase* in sales over those achieved in a standard period. Direct aids are superior to the extent that the payment is conditional. It is much easier for agencies other than an inspector of taxes to ensure that the conditions are complied with.

Selectivity

5.28 Tax concessions are more difficult to apply selectively. It is difficult to draft legislation which ensures that the tax incentive will apply to the concerns to which it is intended and to them only. This lack of control is probably the most serious problem arising with tax incentives and is shown most clearly by the fact that it was necessary to apply the reduced rate of tax on manufacturing profits not only to new ventures and major expansions but also to all existing operations.

Administrative Considerations

5.29 It is likely that direct aids are more costly to administer than tax concessions. These additional costs may involve delay and require extra staff in both the public and the private sector. The resources necessary to administer the tax system are already in place and tax reliefs can be introduced at marginal administrative cost. Therefore, the decision depends on whether the additional administrative costs of a system of direct aids will be more than offset by a more selective application of aid than can possibly occur through a system of tax reliefs.

Measuring the Effectiveness of Incentives

5.30 Tax incentives are introduced to achieve specific objectives. The fact that an incentive exerts the influences outlined above does not necessarily mean that it will be successful in achieving the objective which it is designed to achieve. To be successful the benefits must outweigh the costs arising from the diversion of resources from other uses. It is essential, therefore, that procedures be instituted to enable the government to assess the effectiveness of tax incentives on a regular basis. To facilitate this review, targets which the introduction of the incentives are expected to achieve should be set down in advance in the tax expenditure budget which we proposed in our first report.[2] We do not underestimate the difficulties of doing this. However, we believe that explicit and public attempts to specify the objectives of policy would contribute to greater efficiency.

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[2]Recommendation 1.

Conclusion

5.31 In this report we are concerned, under our terms of reference, with the efficient use of the tax system as a means of altering market sector decisions. In this chapter we have examined the main forms of intervention open to government, including tax incentives, and commented on some of their merits and drawbacks. The need for selectivity, considerations of transparency, accountability and the reduced value of tax-based incentives under our proposals for a lower rate of corporate taxation point in the direction of direct aids. Consequently, we recommend that the government favour the use of such aids rather than tax exemptions or allowances, as far as possible, when it decides to influence the allocation of resources. However, we recognise that there may be times when the government feels constrained to use tax incentives. If it should do so, we recommend that every effort be made to ensure that the benefits of pursuing such a course outweigh the costs and that such incentives be examined on a systematic basis.

Part II

Evaluation of Tax Incentives

INTRODUCTION

1 Our first report proposes a system of direct taxation which involves a radical reform of the existing system. It will take a number of years to implement the new system fully and appropriate transitional measures are needed. These are discussed in Chapter 11. The new system will create an environment which is much more favourable to enterprise than the existing system. Given the overriding importance of substantially increasing the rate of economic development, however, selective incentives will be necessary. In this part of the report we examine the existing range of incentives, with particular reference to the system we propose, and consider certain other incentives and disincentives which have been suggested to us.

2 The principal economic attraction and incentive for growth in the Irish economy arising from our first report is the idea of a single and low rate of taxation. The lower this rate can be, the greater the incentive provided.

3 The discussion in this part of our report is divided into chapters as follows:

(i) Tax Reliefs Applied to Profits (Chapter 6);

(ii) Incentives for Investment (Chapter 7);

(iii) Incentives and Employment (Chapter 8);

(iv) Miscellaneous Incentives (including tax-related lending) (Chapter 9).

In Chapter 10 we examine new incentives which were suggested to us.

CHAPTER 6

TAX RELIEFS APPLIED TO PROFITS

Introduction

6.1 In this chapter we consider the reliefs which are granted on profits with a view to encouraging faster economic growth. The main reliefs in this category are

(i) export sales relief,

(ii) Shannon relief,

(iii) relief of manufacturing profits,

(iv) exemption of certain co-operative societies,

(v) exemption of income from stallions, and

(vi) exemption of profits from woodlands.

Export Sales Relief

6.2 Export sales relief was introduced in 1956. The relief applies to profits derived from certain export sales for a period of up to twenty years. With the exception of cases in which assurances have been provided by the Industrial Development Authority, no company commencing to trade after 1 January, 1981 will qualify for the relief. In no case will relief be granted in respect of any period after 5 April, 1990. Further details of the relief are contained in Appendix 5.

6.3 The Industrial Development Authority informed us that

> "export sales relief has proved to be and is recognised internationally as a highly effective incentive in encouraging manufacturing investment and exports. Research has shown that industrialists who have set up in Ireland ranked export sales relief as the most important single element in the package and central to their decision to invest here. The scheme became particularly effective on Ireland's joining the EEC. There are 438 foreign projects (1980 figures) operating in Ireland of which 60 per cent have been approved since 1973. The scheme has

been increasingly used by domestic companies in export directed investment".

6.4 Export sales relief applied fully to export sales generated by domestic investment. For this reason it was effective prior to 31 December, 1980 in encouraging new export oriented domestic investment. It did not encourage investment geared towards serving the expanding domestic market. On the other hand, the export bias of the relief discouraged unfair competition on the home market between new companies entitled to the relief and established companies that did not benefit from it.

6.5 One of the main objectives of export sales relief was to develop exports and the outstanding growth of exports in the late sixties and throughout the seventies is partly attributable to the relief. The relief does not apply to domestic sales. This is so even when such sales would not adversely affect domestic firms, or where a company sells to another (other than an associated company) whose entire production is exported. A study carried out in 1975 "found that the export outlook and the incentive to export were important in encouraging technological innovation in Irish firms due to the limitations of the home market".[1]

6.6 Three main difficulties arose in relation to export sales relief. Firstly, there was tax avoidance through abuses of the provision relating to tax free dividends on special preference shares. Secondly, the question of what constituted a new trade for the purpose of a new span of relief gave rise to some administrative difficulty. The third was the question of what constituted 'manufacturing'. However, none of these difficulties was very serious and export sales relief worked very well in practice.

6.7 We conclude that export sales relief was an important element in promoting Ireland's industrial development. The relief is now in the process of being phased out. Most of the companies which now qualify for the relief were attracted to Ireland on the basis that their profits would be free of tax up to 1990. Any change in the relief before then would damage seriously Ireland's reputation as a country which provides a favourable and stable environment for business and could reduce the flow of foreign investment. For this reason we assume that export sales relief will be permitted to run its course until 1990.

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[1] *Industrial Policy and Development: A Survey of Literature from the Early 1960s* — NESC Report No 56, December, 1980, Page 34.

Relief on Dividends paid out of Export-relieved Profits

6.8 This aspect of export sales relief was discussed in our first report[2]. We recommended that the arrangement, whereby dividends paid out of export-relieved profits carry an equivalent amount of relief from tax in the hands of the shareholders, should remain unaltered.

Shannon Relief

6.9 The profits of a company from certain trading operations carried on in the customs-free area of Shannon Airport are exempted from corporation tax up to 5 April, 1990. Any company commencing to trade after 1 January, 1981 will not qualify for the relief, except in cases in which certain assurances have been given by the Industrial Development Authority. Full details of the relief are given in Appendix 5.

6.10 Shannon relief was designed to promote the use of Shannon Airport as an industrial and service centre and to increase traffic through the airport. It differs from export sales relief in that it completely exempts the qualifying company from tax up to 1990 for all trading profits and places greater emphasis on the development of export oriented service industries. Ireland ceased to offer this incentive from 1 January, 1981. The considerations that arise in deciding the future of Shannon relief are similar to those for export sales relief. We assume that Shannon relief will be allowed run its course until 1990.

Relief of Manufacturing Profits

6.11 On 20 December, 1978 the Minister for Industry, Commerce and Energy announced that the schemes of export sales relief and Shannon relief would be replaced from 1 January, 1981 by a new incentive scheme based on a reduced rate of corporation tax applicable to Irish manufacturing industry generally. The relief was enacted in the Finance Act, 1980. This provides effectively for a rate of tax of 10 per cent on profits from manufacturing. Full details of the relief are given in Appendix 5.

6.12 We assume that the reduced rate of tax on manufacturing profits will continue until it is due to expire at the end of the year 2000. To abandon the relief would damage Ireland's reputation as a country which provides a stable and favourable fiscal environment for foreign investment.

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[2]Paragraph 11.45.

Manufacturing Profits after the Year 2000

6.13 The reduced rate of tax on manufacturing profits is due to expire at the end of the year 2000. This relief will diminish in attractiveness as the end of this decade approaches. For this reason, any alternative will have to be publicly announced well before the present relief is due to expire. It is extremely important that planning begins now as to what, if anything, should replace the reduced rate of tax.

6.14 The main disadvantage with the reduced rate of tax on manufacturing profits is that it is not related to a suitable measure of performance from the state's point of view. The amount of relief varies with the size of profits rather than the amount of value-added, which would be more appropriate. Since the reduced rate of tax had to be extended to existing as well as new activities in the interests of fair competition, the relief was inefficient in that windfall gains accrued to existing operators. At best this resulted in a larger share of markets leading to a higher level of income, employment and production and an improvement in the balance of payments. At worst the windfall gains were frittered away in cost increases.

6.15 The right objective for policy is to create an economic environment which is favourable to investment. If this is done there is little need for incentives. Incentives have a role to play in the transition. Between now and the year 2000 a favourable economic climate can be created if the problems now evident in the economy are tackled. Part of this favourable environment relates to an improved taxation system. In a situation in which our recommendations are implemented, in particular in the area of inflation adjustment of profits and the removal of employers' social insurance contributions, we consider that manufacturing profits should be charged to tax at the single rate recommended in our first report. In these circumstances, we recommend that manufacturing profits should be charged to tax eventually at the same single rate that applies to other income which, as we indicated in our first report, would be relatively low. The transitional arrangements up to the year 2000, including the treatment of dividends paid out of manufacturing profits and the issue of the primary fund, are dealt with in Chapter 11.

Co-operative Societies

6.16 Co-operative societies qualify for special tax treatment. In the case of an agricultural society or a fishery society, exemptions from tax are granted in respect of certain trading profits and special provisions apply regarding discounts and share and loan interest paid. The tax treatment of co-operative societies is described in Appendix 6.

6.17 In the course of a submission supporting the present exemption the Irish Co-operative Organisation Society Ltd explained that

> "Because of the demands of modern business for capital as a result of changing technology and inflation, members of co-operatives in striking the price at which they trade with their co-operative arrange to leave sufficient profits in the co-operative, not only to maintain an adequate capital base but also to facilitate retirement of debts and investment in diversification and growth. Such profits are not a return on the original capital but rather a decision taken democratically on behalf of the trading members to accept a lesser price to ensure the stability of their outlet".

6.18 Co-operatives are mutual societies. It made sense to exempt the income of agricultural co-operatives from tax when farming profits were not charged to tax. Certain farmers were charged to income tax on the basis of their profits for the first time in 1974 and this charge has been extended to all farmers since 1983. Before this any tax on co-operatives could have been avoided by the shifting of their profits to farmers through the payment of higher prices. Now that all farmers are chargeable to income tax on their profits the situation has changed.

6.19 It has been argued that because co-operatives operate under different regulations than apply to companies, they should qualify for special tax treatment. We do not accept that this provides a justification for special tax concessions.

6.20 The point has been made to us that there should be special tax treatment of dairy co-operatives on the grounds that they have statutory obligations, for example to collect milk from dairy farmers in their areas even where this is a totally uneconomic proposition. In our view a tax exemption for profits is not an appropriate method of compensating co-operative societies for obligations of this kind since, in fact, the two factors are unrelated. The additional costs imposed by these obligations cannot be related to profits and the value of any tax exemptions.

6.21 We have defined profit for tax purposes as that which remains after maintaining the entity intact as a going concern. If the income generated by co-operative societies is more than sufficient to do this, then such income should be subject to taxation. We see no case for treating co-operative societies differently from other businesses for tax purposes. With the proposals in our first report this should not cause any difficulties for co-operative societies. We recommend that co-operative societies should operate under the same taxation provisions as other businesses.

Income from Stallions

6.22 Income arising to the owner or part owner of a stallion from the sale of services or the right to services is exempt from tax. Losses may not be set off against other income. Where a company is in receipt of exempt income from this source, the benefit of exemption is passed on to the shareholders on any dividends paid. The exemption was introduced in 1969 following a recommendation made to the Minister for Agriculture by the Survey Team on the Horse Breeding Industry set up in 1965.

6.23 Income from a stud farm is charged to tax in the same way as other profits from farming. The income which is charged to tax in full includes income from the keeping of mares and stallions at the farm. The only income which is exempt from tax is income arising from stallion fees.

6.24 The Irish Bloodstock Breeders' Association advised us that

> "One of the main reasons why foreign owners have syndicated their stallions in Ireland is the present favourable tax treatment, in that the profit earned from the servicing of mares is exempt from taxation here".

The Association went on to argue that the availability of good stallions, together with the high reputation of Irish breeders, has led to more foreign owners boarding their mares in Ireland, thus creating substantial employment in rural areas.

6.25 The exemption of such fees in Ireland is a major incentive to owners of top-class stallions to stand them in Ireland rather than in the United States where more money is available. This results in foreign broodmares being sent to Ireland to be covered by stallions standing in the country, thereby generating foreign earnings and employment.

6.26 If the exemption of stallion fees were to be abolished it is probable that foreign-owned stallions would leave Ireland. This would lead to a fall in the quality of Irish-bred horses and would have an adverse effect on the sale of horses.

6.27 It is clear that breeding of top-class horses is an internationally mobile activity. Ireland has a national advantage in the industry arising from the high reputation and skill of its breeders. The tax regime applying here must take account of that offered in competing countries.

6.28 We conclude that, in principle, income from stallion fees should be treated for tax purposes in the same way as income from other activities. However, the loss to the economy from imposing such taxation could be considerable. The health of the industry in Ireland depends to a large extent on a relatively small number of prestige stallions standing here. These are mainly foreign-owned and could be exported without difficulty.

6.29 We recommend that income from stallion fees be relieved from tax to whatever level is necessary to ensure the continued development of the industry in Ireland.

Taxation of Profits from Woodlands

6.30 At present, woodlands enjoy special treatment for tax purposes. Profits are exempt from both income tax and corporation tax. However, losses are not allowed against other income. Distributions by companies out of exempt profits are free of tax in the hands of shareholders.

6.31 Investment in forestry is long-term. The income from such investment arises in a few years at the end of the growing period. Under a progressive income tax system, special treatment of income from woodlands is essential in the absence of averaging of income over a very long period. Such problems do not arise when income is charged to tax at a single rate.

6.32 The issue arises in relation to forestry and other long-term investments about the treatment of losses which arise in the early years of the investment. Under our proposals, such losses would be set against other income. In our view, this would provide sufficient incentive for long-term investment.

6.33 In Ireland, state-owned woodlands greatly exceed private woodlands. Only about 15 per cent of the area covered by woodlands is now privately owned and this is primarily old forest. The potential for forest development in Ireland is significant. A study[3] by the National Economic and Social Council concluded that

> "The growth rate (of trees) in Ireland is strikingly higher than that of the other countries listed. It is almost double the EEC average and 19 per cent higher than Denmark's, its closest competitor".

6.34 While it is desirable that forestry should be developed so as to achieve this potential, tax incentives to encourage private investment in woodlands are an indirect and inefficient means of doing this. What appears more important is, for example, investment in and development of the processing and marketing aspects of the industry.[4] The potential savings of foreign

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[3]*Irish Forestry Policy*, NESC Report No. 46 p38.
[4]NESC Report No 46, Chapter 9 and 10.

exchange are considerable for this country's economy, both through exports and import substitution.

6.35 We conclude that once tax is levied at a single rate, the case for special treatment of income from woodlands no longer exists. In these circumstances, we recommend that income from woodlands be subject to the same treatment as income from other sources, subject to appropriate transitional arrangements. If incentives are considered desirable, we consider that these can best be provided directly.

Recommendations

6.36 In the context of the general scheme of taxation in our first report we make the following recommendations:

1. Commitments given under export sales relief, Shannon relief and the relief of manufacturing profits, whether these are enforceable contractual obligations or not, cannot be repudiated without causing serious damage to Ireland's reputation as a suitable location for foreign investment. There is no alternative to honouring these commitments.
2. Once the present special relief for manufacturing profits expires, such profits should be charged to tax at the same single rate which applies to other income.
3. Co-operative societies should operate under the same taxation arrangements as other businesses.
4. Income from stallion fees should be relieved from tax to whatever extent is necessary to ensure the continued development of the industry in Ireland.
5. Income from woodlands should be subject to the same tax treatment as income from other sources. Losses, which are at present disallowed, should be allowed against other income.

CHAPTER 7

INCENTIVES FOR INVESTMENT

Introduction

7.1 In this chapter we consider the incentives which are provided through the tax system to encourage increased investment. Before examining these in some detail we consider the evidence available regarding the rate and efficiency of investment in Ireland.

Investment in Ireland

7.2 Table 1 sets out the main trends in investment and consumption in Ireland since 1975.

TABLE 1

Investment in Ireland 1975-1983

Year	Gross Investment[1] (1)	Net Investment[2] (2)	Private Investment[3] (3)	Consumption[4] (4)	Total Spending (Col 1 + Col 4) (5)
	%	%	%	%	%
1975	23.3	18.8	10.5	83.0	106.3
1976	24.7	21.3	12.5	82.0	106.7
1977	25.0	20.7	13.6	80.9	105.9
1978	27.8	22.8	15.8	80.8	108.6
1979	31.3	26.9	18.2	82.7	114.0
1980	29.4	25.6	15.0	85.2	114.6
1981	29.7	27.3	13.4	85.7	115.4
1982	25.8	23.1	10.2	80.3	106.1
1983	23.9	20.8	9.9	78.8	102.7

Source: National Income and Expenditure and Department of Finance.
Notes: (1) Gross domestic fixed capital formation as a percentage of gross domestic product.
(2) Gross domestic fixed capital formation (GDFCF) minus depreciation as a percentage of national income.
(3) GDFCF minus public capital expenditure as a percentage of gross domestic product. A substantial part of the public capital programme goes to finance private investment.
(4) Total consumption expenditure as a percentage of gross domestic product.

7.3 Investment is not desirable in itself but only in so far as it augments the productive capacity of the economy to provide an increased flow of goods and services in the future at competitive prices. In Ireland there has been a consistently high rate of gross investment to gross domestic product — the average level since 1975 being 26.7 per cent. However, the investment rate has declined steeply from the peak attained in 1979. Investment ratios of this level might be expected to result in very rapid rates of growth in output, which have not materialised.

7.4 There are a number of dangers in drawing conclusions based on gross investment rates. Firstly, the figures exclude investment in stocks and working capital, which is as important for achieving growth as investment in fixed capital. Secondly, to arrive at a definite conclusion about the efficiency of investment, it is necessary to compare net investment rates after providing for depreciation with growth rates. Net investment rates are shown in column 2 of Table 1. However, there are difficulties in obtaining precise estimates of depreciation in the National Accounts and the estimates that are available are subject to a margin of error which makes it difficult to draw conclusions. Nevertheless, the figures suggest that net investment has been high and that the return in terms of growth has been disappointing.

7.5 Gross private investment as a percentage of gross domestic product is shown in column 3 of Table 1. Private investment increased steadily between 1975 and 1979. Since then it has fallen steeply and is now at its lowest level in nearly a decade.

7.6 Our general conclusion is that the returns from the substantial investment which has been undertaken have been disappointing. What is required is not so much an increase in investment as an increase in its efficiency. A number of recommendations in our first report will contribute to this.

- Firstly, our general recommendations, involving as they do a significant increase in free competition for the savings of the community, should contribute to more efficient use of savings in more productive investment projects, which would have higher returns in terms of growth and employment.

- Secondly, the adjustment of the tax system to take account of the effects of inflation should increase the relative attractiveness of productive investment, which is very much reduced in times of high inflation.

- Thirdly, our recommendations for a social security tax should remove a disincentive to employ labour by discouraging the mere substitution of men by machines.

- Fourthly, our recommendations in relation to housing should result in a reduction in wasteful investment in housing.
- Finally, the introduction of realistic taxation of fringe benefits should result in some reduction of investment in motor vehicles.

DEPRECIATION

7.7 In our first report[1] we recognised that the exhaustion of an asset in the course of its use is one of the elements of cost in a business enterprise. Therefore, to arrive at a proper estimate of income, an appropriate proportion of the total depreciation relating to an asset must be charged against income for each year of the estimated useful life of the asset. This matches revenue earned in a particular year against the wear and tear of assets used to generate that revenue.

7.8 We also recognised[2] that to obtain a true estimate of income derived from business activities it is necessary to take account of 'true' economic depreciation. Ideally, we would like to arrive at a situation in which the depreciation charged in company accounts would be allowed for tax purposes. It is argued that this could introduce an element of subjectivity into the tax system. We concluded that, pending developments in generally accepted accountancy practice, deductions in respect of depreciation should continue to be given in the form of capital allowances.

7.9 We left open the question of accelerated capital allowances for incentive purposes until this report. This is the issue we examine now.

7.10 The existing position in relation to the treatment for tax purposes of depreciation, including the accelerated capital allowances now available, is set out in Appendix 20 to our first report. The historical background to the allowances is also outlined.

Accelerated Depreciation

7.11 Accelerated depreciation in the form of free depreciation was introduced in 1967 in respect of new machinery or plant (other than road vehicles) provided for use in the designated areas, mainly located in the West of Ireland. The option to elect for free depreciation was extended to the rest of the country in 1971 for similar new machinery or plant brought into use on or after 1 April, 1971. This was originally introduced for two

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[1]paragraph 26.57.
[2]paragraph 26.65.

years "as a special measure to encourage a concentration of capital investment in the two-year period ending 31 March, 1973".[3]

7.12 Free depreciation was extended in 1973 for a further period of two years. In doing so the Minister for Finance stated:

> "I am conscious of the need to provide every incentive possible to assist Irish industry in the task of re-equipping and modernising itself to enlarge further its export markets and to face growing competition from abroad in the home market"[4].

A further extension for a period of two years was announced in 1975. In coming to this decision:

> "the Government have been influenced mainly by the need to stimulate investment at this time and by the advantage of assisting Irish industry to equip itself for the highly competitive years that lie ahead."[5]

7.13 The established pattern was followed in 1977 when free depreciation was extended for a further period of two years. The Minister for Finance justified this on the grounds that:

> "If these provisions are not renewed, the allowances for investment in plant and machinery . . . . . will revert to levels which although realistic, might not be regarded as offering a sufficiently attractive inducement for investment at present. The Government have decided to extend for a further period of two years the existing arrangements."[6]

7.14 Free depreciation was made permanent in 1978. This was done on the basis of a complete change in the philosophy underlying the relief, as is made clear by the Minister's statement:

> "The purpose of the short-term basis of free depreciation in the past was to stimulate early investment by manufacturing industry as well as to keep options open in the matter of the long-term level of capital allowances for new plant and machinery. The Government have decided that the need for industrial growth would be better served by allowing free depreciation for plant and machinery as a normal and continuing feature of our capital allowances arrangements for the whole country."[7]

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[3]Budget Speech 19 April, 1972.
[4]Budget Speech 16 May, 1973.
[5]Budget Speech 15 January, 1975.
[6]Budget Speech 26 January, 1977.
[7]Budget Speech 1 February, 1978.

Analysis of Free Depreciation

7.15 We now compare the benefit of free depreciation with normal depreciation as envisaged in our first report. Normal depreciation at a rate intended to spread the difference between the cost of the asset and its residual value over its useful working life would be applied to original cost (if the straight-line method were used) or to written-down value (for the reducing balance method), but each year the original cost or written-down value would be increased by an inflation factor corresponding to the average rate of inflation — in our view, the consumer price index would be appropriate.

7.16 We commissioned an analysis to compare the effects of 'normal depreciation', as envisaged in our first report, and free depreciation. The results showed that in any given profit flow, total post-tax profits in real terms are larger under free depreciation than under normal depreciation. If free depreciation is only allowed up to the amount of the residual value of the asset, post-tax profits in real terms are the same under both approaches. In this case, the results are not sensitive to annual pre-tax profit flows, inflation rates, asset lives, the period between the final year of depreciation and the disposal of the asset or the residual value of the asset. The results are sensitive to whether or not interest rates are positive or negative in real terms. If real interest rates are positive, free depreciation to residual value is more favourable than normal depreciation. The reverse is true if real interest rates are negative. However, in all cases free depreciation results initially in a better cash flow than normal depreciation.

7.17 We do not consider that the granting of accelerated capital allowances is an efficient method of promoting industrial investment. Quite apart from the arguments that arise about such reliefs distorting investment decisions, difficulties arise from the range of assets which are regarded as machinery and plant. There is no statutory definition of machinery or plant but the Courts have given the terms a very wide meaning. Plant has been interpreted as including:

> "Whatever apparatus is used by a businessman for carrying on his business — not his stock-in-trade which he buys or makes for sale; but all goods and chattels, fixed or moveable, live or dead, which he keeps for permanent employment in the business."[8]

7.18 As a result, free depreciation may be claimed, not only on what would commonly be thought of as plant, such as industrial machinery, but also on such items as fixtures and fittings in a retail shop or office furniture.

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[8]Lindley L. J. in the case of *Yarmouth v France*, 19 QBD 647.

It is difficult to see how incentives for these items encourage industrial growth. A case can be made for restricting incentive tax allowances to certain industries or to a narrower range of machinery or plant (e.g. 'productive' assets). Such restrictions might give rise to practical difficulties, particularly if based on types of assets rather than sectors.

Administrative Considerations

7.19 We discussed these alternative approaches with the Revenue Commissioners who favoured the continuation of free depreciation for those assets currently qualifying for that relief. They informed us that they:

> "would not welcome a return to the pre-1968 position involving a multiplicity of rates for assets of varying lives".[9]

7.20 We do not consider that the administrative considerations are sufficient of themselves to justify retaining free depreciation. Most of the compliance costs of a change would fall on business. In our view, these would be more than offset by the increased efficiency which should result from business having to adopt accurate depreciation policies for tax purposes.

7.21 For these reasons we recommend a change from free depreciation to normal depreciation on an indexed basis.

7.22 Some transitional problems arise in making a switch from free depreciation to indexed depreciation over the normal life of the asset. Our views on how these should be dealt with are set out in Chapter 11.

CLASSES OF ASSETS

7.23 We now consider how the principles we have outlined should be applied to the various classes of assets to which capital allowances already apply and assets in respect of which we received submissions proposing the improvement of the capital allowances which apply. These assets are

(i) new machinery and plant,

(ii) second-hand machinery and plant,

(iii) lorries,

(iv) motor vehicles,

(v) industrial buildings,

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[9]Letter of 16 March, 1982.

(vi) hotels,

(vii) farm buildings,

(viii) ships,

(ix) multi-storey car parks,

(x) toll roads and bridges,

(xi) dredging,

(xii) research and development,

(xiii) patent rights and royalties,

(xiv) rented accommodation, and

(xv) quarries.

New Machinery and Plant

7.24 New machinery and plant qualifies for free depreciation. We recommend that capital allowances in respect of new machinery and plant be provided on an indexed basis to write off the cost of the asset to its residual value over the estimated useful life of the asset. Residual values and estimated useful lives of broad classes of assets would have to be set down in regulations, following consultations between the Revenue Commissioners and the relevant professional bodies.

Second-hand Machinery and Plant

7.25 We received submissions which pressed for the extension of free depreciation to second-hand machinery and plant. We raised this issue with the Department of Finance who told us that:

> "The State's policy towards investment in new industry must be geared to ensuring that the most up-to-date technology is acquired so that a sound base of efficient and competitive industry is built up. Tax incentives for second-hand plant are not consistent with such a policy .... The main effect of the proposal might be to stimulate the transfer of obsolete equipment by multinationals to their Irish subsidiaries".[10].

7.26 The distinction applied by the capital allowances legislation between new and second-hand plant and machinery dates from the time that free depreciation was introduced as an incentive to encourage industry to modernise its equipment. Our proposals are intended to remove any

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[10]Memorandum of 23 November, 1981.

incentive element in capital allowances for tax purposes. In these circumstances, we recommend that the tax code ought to provide the same reliefs for second-hand assets as is available for new assets.

Lorries and Motor Vehicles

7.27 At present, depreciation on lorries and motor vehicles[11] is allowed at a rate of 20 per cent of the historical cost on a reducing balance basis. This has the effect of writing off almost 90 per cent of the original value of lorries and motor vehicles over a period of 10 years. We recommend that capital allowances be given on an indexed basis at a rate sufficient to write off the cost of such assets to their residual values over their normal useful lives.

Buildings

7.28 In our first report we recommended that, leaving aside any question of incentives, an allowance for capital wastage on buildings (except those which are custom-built for specific industrial purposes) should be granted on realisation only. We recognised that to obtain a true estimate of income derived from business activities (under a comprehensive definition of income), it would be necessary to allow true economic depreciation in respect of fixed assets, including buildings, and to take account of real capital gains as they accrue. Therefore, in principle, it is necessary to grant capital allowances, not only on industrial buildings but also on commercial buildings including shops, offices and rented residential property. Our proposal to take account of depreciation of buildings was a departure from the correct treatment in principle which we recognised in our first report. A similar departure was made in the case of capital gains and losses which we recommended should also be dealt with on realisation. Both of these recommendations must be justified on administrative grounds.

7.29 Our recommendations regarding the depreciation of buildings have attracted considerable criticism, most notably from the accountancy profession. In particular, we recognise that inequity could arise in cases where taxpayers had no income against which to offset a balancing allowance for capital wastage on realisation. We propose to return to the depreciation of all buildings in our final report. In this report we deal with those buildings to which accelerated capital allowances now apply. In general, we are satisfied that capital allowances on these assets should be at normal rates spread over a realistic asset life and should be indexed. In choosing an asset life, obsolescence may be ignored since it is appropriate to take account of this on realisation.

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[11]Capital allowances on motor vehicles are restricted to a total of £3,500 in respect of each vehicle. Recommendation 131 of our first report was that allowances for such vehicles should be allowed in full to the business entity.

Industrial Buildings

7.30 We have concluded that if incentives are necessary to encourage the provision of industrial buildings, it is more efficient to provide these directly rather than through the tax system. Accordingly, we recommend that accelerated capital allowances for industrial buildings be withdrawn. These should be replaced by depreciation at normal rates on an indexed basis.

Hotels

7.31 Free depreciation was extended to hotels in respect of expenditure incurred on or after 2 February, 1978. Grant schemes are also available to help hoteliers to meet the financial costs of expansion. We consider that the provision of accelerated capital allowances is not an efficient method of encouraging investment in hotels, even if this were to be regarded as an appropriate priority for tourism policy. Aid in this form can take little account of the type of accommodation provided or whether it is provided in the areas in which the shortage of such accommodation is greatest. For these reasons, we recommend that any incentives for hotel-building which are deemed necessary should be provided directly. If incentives are provided directly, it is more likely that the overall national expenditure on development of tourism will be spent more efficiently if greater flexibility is provided to devote a greater or lesser proportion of funds to promotion, depending on market conditions. On this basis we recommend that accelerated capital allowances and free depreciation for hotel buildings should be withdrawn. These should be replaced by normal depreciation on an indexed basis.

Farm Buildings

7.32 Expenditure on farm buildings may be written off over a period of between four and ten years with up to 30 per cent being claimed in any one year. A minimum of 10 per cent must be claimed each year. This relates only to expenditure incurred after 6 April, 1980. These allowances can be claimed on the construction of farm buildings, fences, sewerage, water and electricity installation and reclamation of former agricultural land. Expenditure incurred on or after 6 April, 1977 on the construction of fences, roadways, holding yards and drains or on land reclamation can be written off in one year.

7.33 We consider that farm buildings and other items coming within the scope of the allowance should be treated the same way as industrial buildings.

Ships

7.34 Expenditure on new and second-hand ships qualifies for an initial allowance of 100 per cent. An investment allowance of 40 per cent was introduced in 1957 for expenditure on new ships. The allowance was suspended with effect from 23 July, 1973. We received submissions that it be restored.

7.35 We consider that if investment incentives are deemed necessary to encourage investment in new ships, it is more desirable, from the point of view of public accountability, if such reliefs are given directly. We recommend that indexed capital allowances in respect of ships be given on a basis which would write them off to their residual value over their estimated useful lives.

Multi-Storey Car Parks

7.36 An initial allowance and an annual allowance is available in respect of capital expenditure incurred on the construction of multi-storey car parks used for the purpose of a trade of providing parking space for members of the general public. The initial allowance at a rate of 50 per cent and the annual allowance at a rate of 4 per cent applies to expenditure incurred on or after 29 January, 1981 and before 1 April, 1984.[12] Free depreciation is not available.

7.37 We consider that incentives for the provision of multi-storey car parks would be better given in the form of grants through local authorities, if at all. The issue remains whether such buildings should qualify for normal depreciation. Such buildings are akin to commercial buildings of which they may form part. For this reason, we recommend that multi-storey car parks be treated as commercial buildings for the purposes of capital allowances.

Toll Roads, Bridges etc.

7.38 A person is entitled to an allowance of 50 per cent of capital expenditure incurred on the construction of a toll road, (including a bridge, a viaduct, etc.) under an agreement made between him and a local authority under Section 9 of the Local Government (Toll Roads) Act, 1979. The expenditure must be incurred in the period from 28 January, 1981 to 31

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[12]It is proposed to continue these allowances for a further three year period until March, 1987. Budget Speech, 25 January, 1984.