

# Draft NCC Submission to the Commission on Taxation

23 May 2008



# 1. Introduction and Background

The National Competitiveness Council (NCC) is a social partnership body, established by the Government, which reports to the Taoiseach on key competitiveness issues facing the Irish economy together with recommendations on policy actions required to enhance Ireland's competitive position. As a small open economy, our international competitiveness is a key driver of Irish living standards. The taxation system is an important determinant of Ireland's international competitiveness. We welcome the opportunity to provide comments to this review of the structure, efficiency and appropriateness of the Irish taxation system.

Research indicates that the structure of the taxation system has an influence on competitiveness. Individual recommendations in this submission are not aimed at increasing or reducing the overall levels of taxation, rather ensuring that the taxation system is optimised to support competitiveness. It is also important that calls to increase or decrease individual taxes are not automatically characterised as calls to increase or reduce revenues (due to the Laffer curve effects). The NCC also acknowledges that significant investment is required in physical and economic infrastructure to support future competitiveness and generate future tax revenues.

We note that the Commission has requested comments under a number of specific headings. We endeavour to address our points within these headings. More generally, it remains critical that the tax system continues to conform to well accepted tax principles, namely that the system is economically efficient, administratively simple, flexible, transparent and fair.


## 2. Issues Raised by the Commission on Taxation

In terms of the issues raised by the Commission on Taxation:

- a. **Consider how best the tax system can support economic activity and promote increased employment and prosperity while providing the resources necessary to meet the cost of public services and other Government outlays in the medium and longer term;**

To date, Ireland has been broadly successful in using the taxation system to promote employment growth and prosperity. In this context, the NCC believes that the tax system can continue to play an important role.

- In the context of maintaining and promoting increased employment, the NCC regards Ireland's labour tax wedge (i.e. the ratio of total labour taxes to total labour costs) as a competitive advantage (see figure 5 in appendix 1). Relatively low income taxes on labour increase the incentives for individuals to participate in the labour market and supports the enterprise sector in increasing employment numbers. NCC research on the costs of doing business in Ireland highlights that low labour taxes in Ireland enhance the cost competitiveness of labour intensive firms, particularly in the current environment of rising costs. It also enhances the attractiveness of Ireland to highly skilled internationally mobile workers - a key source of competitive advantage.



The social partnership process in Ireland has successfully reduced the tax wedge on labour over the past two decades. We would see the maintenance of a competitive tax wedge as an important guiding principle for taxation policy going forward. However, while the tax wedge supports participation in the labour force for most workers in Ireland, previous NCC research has highlighted that certain categories of workers still face significantly higher tax barriers to participating in the workforce. In particular, the marginal tax rate on second earners should continue to be reduced and the incentives and enabling structures for lone parents to participate in the labour force should be improved. OECD research also indicates that single workers with no children who earn 167% of average wage also face a significantly higher tax wedge - a key category as it is dominated by relatively highly skilled and mobile executives.

- With respect to corporation tax rates, we note that the Commission is not looking for views.
- Ireland's taxation system is an important competitive advantage. However, it is important that we continue to develop additional strengths which may be more sustainable in the long term. Given Ireland's success in recent years and the challenges we currently face, the Programme for Government and Towards 2016 highlight a range of important policy goals that can enhance Ireland's long term development and competitive advantage. The role the taxation system can play in supporting the achievement of these goals needs to be considered carefully. In particular:
  1. Ireland lags a range of other countries in terms of participation rates in life long learning. This is a result of a range of complex social and economic factors. Driven by demographic change (e.g. aging population and longer working lives), economy wide restructuring and increasing competition internationally, developing the skills of the existing workforce is growing in importance. The potential of the taxation system to stimulate demand for life long learning and the supply of enterprise and employee relevant courses needs careful consideration.
  2. The stimulation of innovation is widely accepted to be critical in the development of a competitive economy. Business investment in research and development plays an important role in this context. While Ireland has introduced a R&D tax credit scheme, concerns remain that it not as competitive as that available in other countries. It also appears to be of more limited value to smaller companies. The effectiveness of the R&D tax credit system needs to be reviewed to ensure it is effective, competitive and appropriate to incentivise innovation and skills creation, particularly in SMEs.
  3. Development of a knowledge based economy. As the international business environment has become more complex, a range of countries including Ireland have enhanced the attractiveness of their country as a location for global business. This includes, for example, the approaches taken towards the tax treatment of research and development and intellectual property, and in the development of more extensive tax treaty networks. Further potential exists to make Ireland attractive to knowledge intensive businesses. This requires making Ireland a more attractive location from which to purchase intangible assets (e.g. brands, software, copyright, etc.) and the further extension of Ireland's treaty network.

## **b. Consider how best the tax system can encourage long term savings to meet the needs of retirement;**

Despite a range of generous tax provisions, the take up of pensions remains relatively low in Ireland. The lack of adequate pension coverage has been highlighted by many parties as a key issue for Ireland. At this time, the NCC does not offer any specific recommendations on how these issues should be addressed. We look forward to the outcome of the consideration of this important issue by the Commission.

A variety of approaches have already been suggested, including SSIA type savings schemes and the introduction of mandatory pension contributions. As regards the latter, it would be vital from a competitiveness perspective that any developments in this area should not have the effect of unduly increasing the tax wedge between the costs of employment and the take home pay of employees.

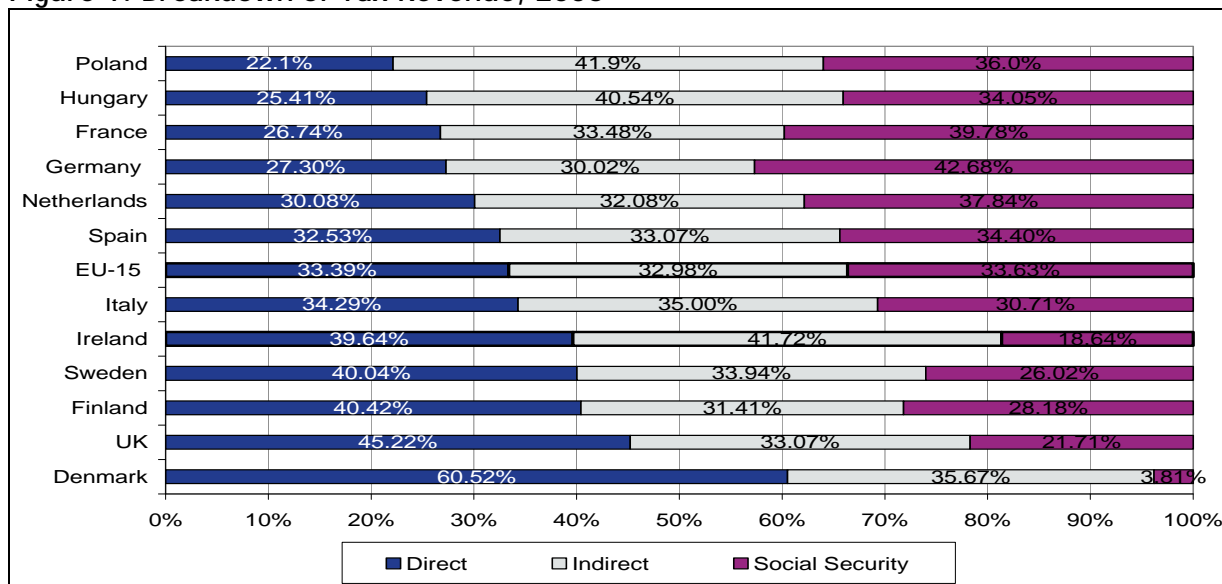
Work is also needed to review the attractiveness of pensions, some of which may have taxation implications. For example:

- Concerns remain that pension schemes are too inflexible to meet customer needs for various important 'life events'. In this regard, some of the innovative features of other jurisdictions (US (401k) and NZ (Kiwi Saver)) which allow for a one-off withdrawal after three years to help in the purchase of the first home, serious illness, financing of post second level education of self/spouse/dependants, or significant financial hardship should be considered.
- Concerns remain over the ability of customers to switch pension providers. It is important to review all tax measures that may act to impede migration between pension types, products and providers.
- While pensions are complex financial products, it is important to ensure that costs associated with pensions are made fully transparent - for example, that pension providers inform the consumer of the amount of their contributions over the lifetime of the pension that will go to commissions and other costs. Likewise, it is critical that tax treatment of pensions and pension contributions are as transparent and administratively simple as possible.

c. Examine the balance achieved between taxes collected on income, capital and spending;

Figure 2 provides a breakdown of Irish tax revenues. It highlights a relatively high reliance on indirect taxes and that the yield from social security contributions is lower than in many other economies. This reflects a policy of reducing taxes on the factors of production (i.e. workers and firms) in order to promote entrepreneurship, enterprise development and participation in the labour force.

Figure 1: Breakdown of Tax Revenue, 2006



Source: OECD

As workers and companies have become increasingly internationally mobile, this policy has also made Ireland an attractive location for overseas firms and migrants. However, it is important that we are aware and address the fact that indirect taxes may have a negative impact on the tourism sector and on the domestic cost environment, particularly for those on low incomes. In the context of targeting lower inflation growth, avoiding excessive increases in customs and excise duties and VAT would support the moderation of inflation.

The importance of taxes on property has grown significantly in recent years driven by the property market boom (greater construction activity and higher taxes as tax bands have not kept pace with property price inflation). Capital taxes (which are dominated by stamp duty) accounted for 14 percent of total tax revenue in 2007 - up from 3.5 percent in 1995. However, the bulk of this yield has arisen from transaction taxes (stamp duty and capital gains) rather than recurring taxes. The yield from these taxes is extremely sensitive to the volume and value of property sales and is now falling due to the downturn in the property market and the fall in property values. Taxes on transactions also reduce liquidity in the housing market as they increase the costs of buying and selling property. This can have negative implications for the efficient use of existing housing stock and constrain labour mobility. In previous reports, the NCC has argued that the Government should tax property stocks rather than property transactions. We acknowledge the difficulties in reforming property taxes. The goal of such a tax on property stocks would not be to increase overall revenues (in the light of falling revenues from

stamp duty) and care would be required not to 'double tax' those who have paid significant stamp duty taxes in recent years.

Ireland has taken significant steps in recent years in reducing the range of incentives in place that support investment in property. The NCC recommends that the Government should continue to shift tax incentives away from investments in property. Strong tax incentives for property have the effect of reducing the incentives for investment in productive assets (e.g. firms) which would stimulate the exporting capacity of the economy and other financial assets (e.g. pensions, shares, etc.). Potential may exist over time to reorient property incentives towards meeting the terms of reference of the Commission in regard to encouraging long term savings to meet the needs of retirement.

**d. Review all tax expenditures with a view to assessing the economic and social benefits they deliver and to recommend the discontinuation of those that are unjustifiable on cost/benefit grounds;**

The NCC does not wish to make any comments on particular schemes. However, the NCC has argued that a clear, transparent and continuous process is required to assess the costs and benefits of taxes and tax exemptions to ensure that they are delivering value for money for the State. In particular, we would argue that tax incentives for investment in all forms of real property should only be considered if they make substantial direct and quantifiable contributions to the enhancement of export competitiveness. Existing tax incentives and expenditures should be reviewed against this criterion and wound down where they do not meet this test.

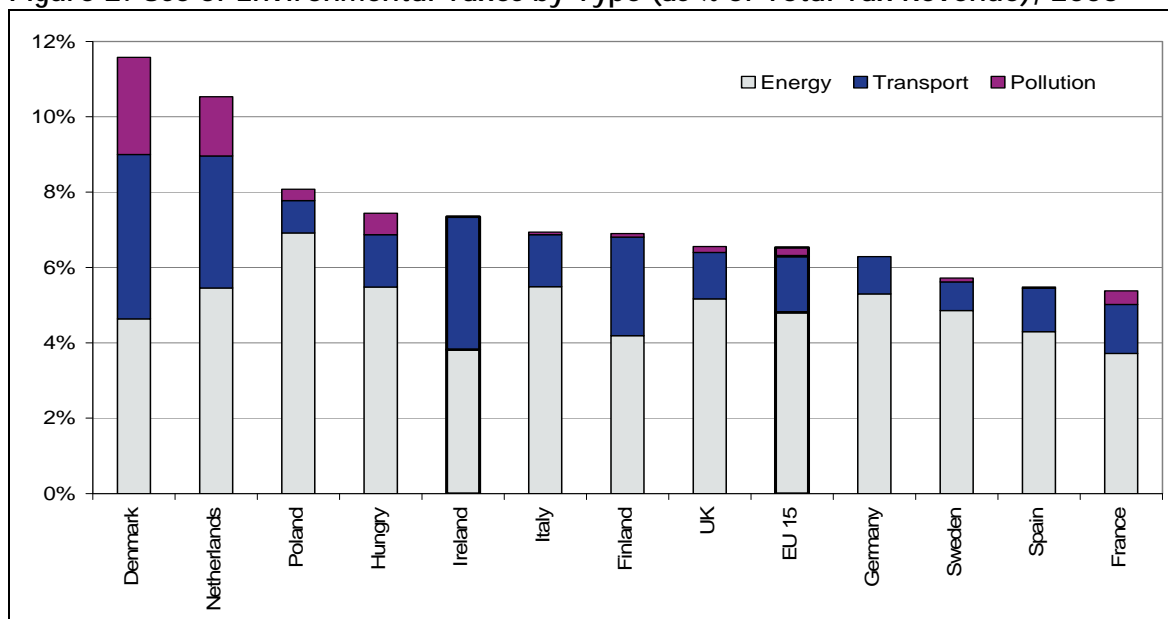
**e. Consider options for the future financing of local government;**

Relatively low corporation and labour taxes enhance the cost competitiveness of all internationally trading businesses in Ireland. However, local authority charges (e.g. water, waste, commercial rates, development charges, etc.) offset these advantages to some degree, particularly for early stage start-up firms. Many of these fees have increased rapidly in recent years. It is important that these charges are transparent, applied fairly and relate to the economic costs of providing the service in an efficient manner. The NCC acknowledges the growing demands being placed on local authorities given rapid population and economic growth. It is notable that the contribution of households to local authorities funding in Ireland is limited. In this regard, in addition to the wider benefits of recurring property taxes, a widening of the revenue base for local authorities, subject to efficiency gains and value for money, should be of benefit.

f. Investigate fiscal measures to protect and enhance the environment including the introduction of a carbon tax.

As highlighted in figure 2, Ireland collects a relatively large proportion of its tax revenue from environmental sources, but Ireland does not tax pollution as some other countries do. Ireland's share of revenues from energy is also below the EU average.

Figure 2: Use of Environmental Taxes by Type (as % of Total Tax Revenue), 2005



Source: Forfás Calculations; Eurostat, Economy and Finance Indicators, 2006 [online]

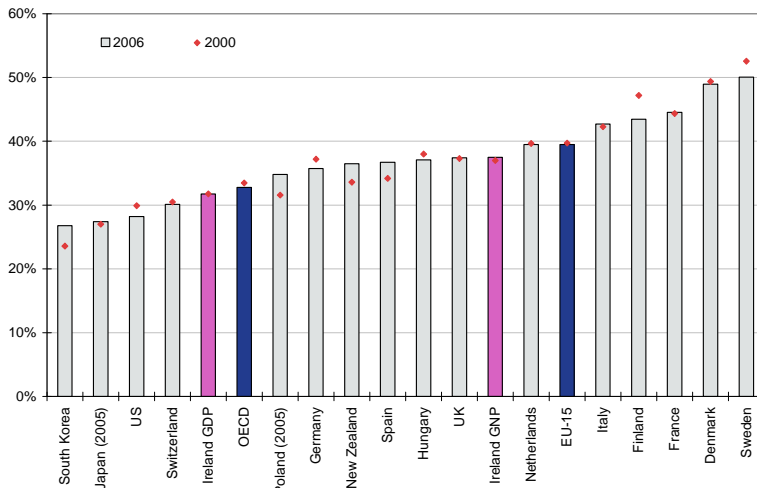
The Programme for Government outlines proposals to introduce measures to further lower carbon emissions and to phase in on a revenue neutral basis appropriate fiscal measures including a carbon levy over the lifetime of the Government.

Building on Forfás research, the NCC suggests that Ireland needs to proceed carefully on the introduction of a carbon tax as the costs of doing business in Ireland have already increased rapidly in recent years. It is also notable that businesses are already facing significantly higher energy costs and are already making significant progress in reducing their energy and carbon intensity. In this context, if a carbon tax is to be introduced:

- It should be introduced at a relatively low rate, and then ramped up over time to match the emission trading scheme carbon price;
- It should be introduced over a sufficiently long time table to enable industry to adjust;
- It should exempt firms who are already engaged in the emission trading scheme and firms that are participating in binding energy-efficiency agreements;
- Finally, it is important that the revenues raised are used to promote incentives to reduce carbon emission further, to ameliorate the competitiveness impacts of the proposed tax, and promote the development of firms and sectors that can capitalise on emerging markets for environmental goods and services.

## Appendix 1: Taxation and Competitiveness - Ireland's Relative Performance

Figure 1 Total Tax Revenue (% GDP), 2006<sup>i</sup>

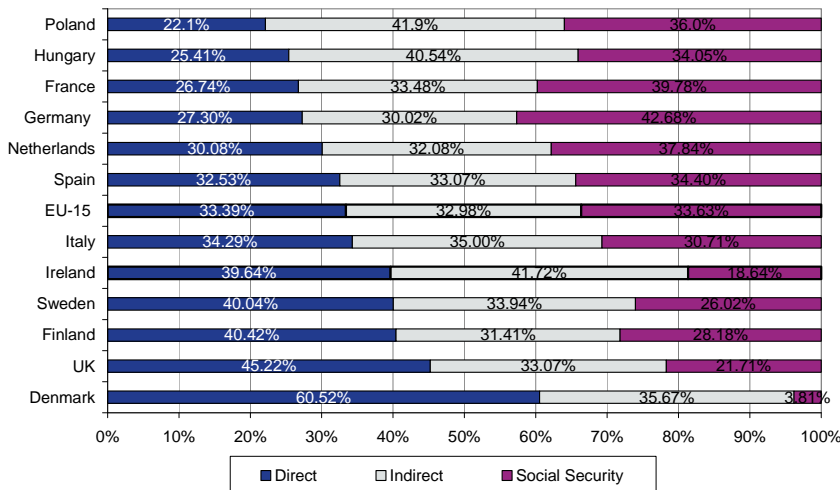


Ireland's tax take, as a proportion of its income (GNP) is above the OECD average. Total tax revenue taken as a percentage of GDP has remained relatively stable across the OECD and the EU-15 since 2000.

Ranking:  
N/A

Source: OECD, Revenue Statistics 1965-2006

Figure 2 Breakdown of Revenue, 2006

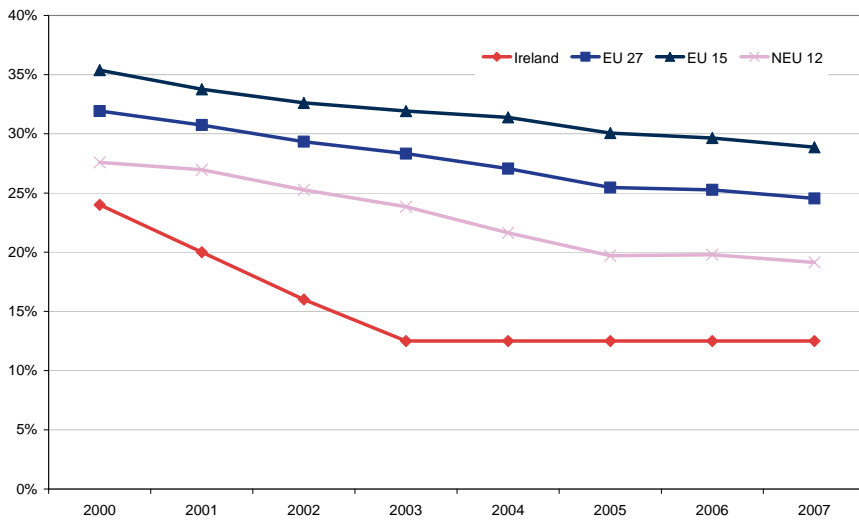


Ireland's tax structure is less dependent on social security contributions than other economies. There is a relatively even split between direct and indirect taxes, reflecting a policy to reduce taxes on factors of production - i.e. workers and firms.

Ranking:  
N/A

Source: Eurostat, Economy and Finance Indicators

Figure 3 Top Standard Tax Rate on Corporate Income (%), 2000-2007ii

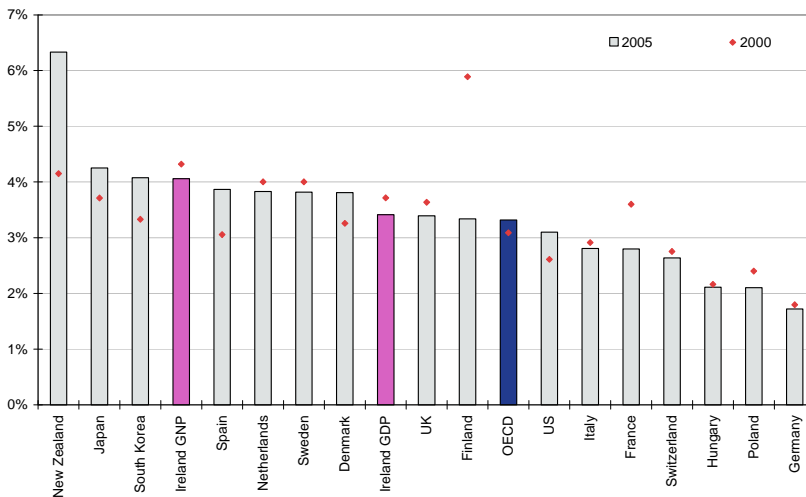


The average top rate of corporation tax in the EU has continued its declining trend as economies seek to create attractive investment environments. At 12.5 percent, Ireland has the third lowest rate in the EU 27.

EU-15 Ranking:  
1 (-)

Source: Eurostat, Taxation Trends in the European Union, 2007

Figure 4 Corporation Tax Receipts as a Percentage of GDP, 2005

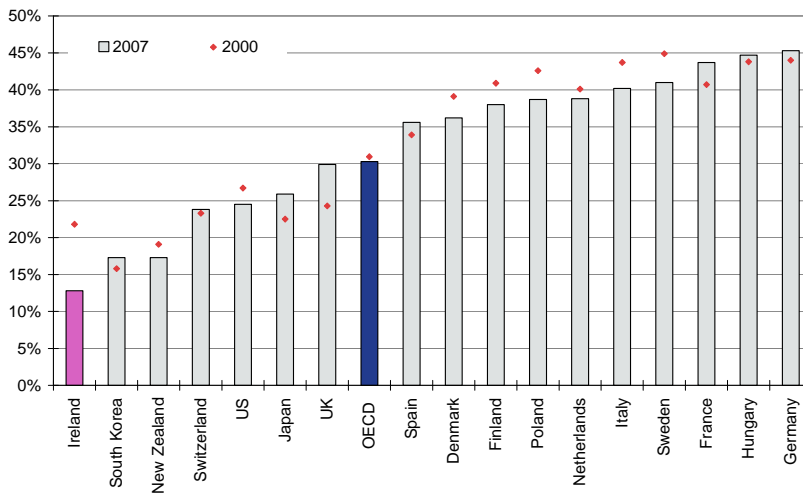


While Ireland's corporation tax rates are low, Ireland earns more in corporation tax payments as a percentage of GDP than most other OECD countries.

OECD-28 Ranking:  
GDP: 14 (↓4)  
GNP: 8 (↓2)

Source: OECD, Revenue Statistics 1965-2006

Figure 5 Total Tax Wedge on Labour (% of Average Earnings), 2007

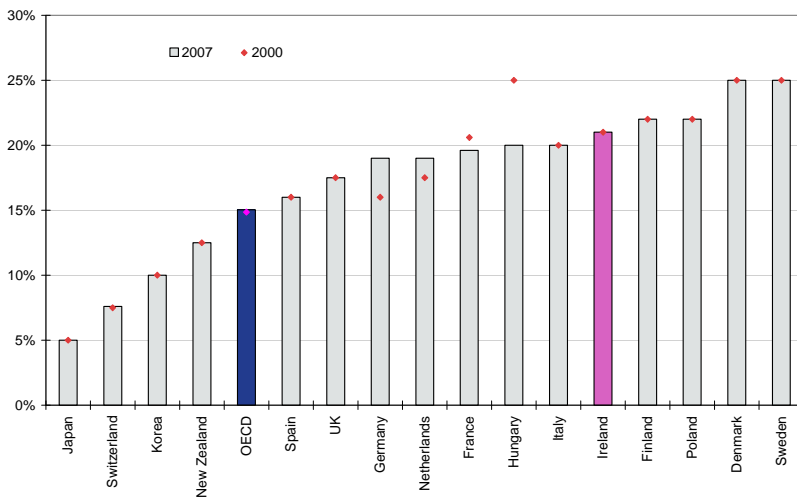


Ireland's tax wedge on labour, i.e. the gap between what the employer pays and what the employee receives has fallen since 2000. Ireland's tax wedge is now the smallest in the OECD and is less than half the OECD average.

OECD-28 Ranking: 2 (↑4)

Source: OECD Taxing Wages 2006/2007

Figure 6 Value Added Tax, Standard Rate, 2007<sup>iii</sup>

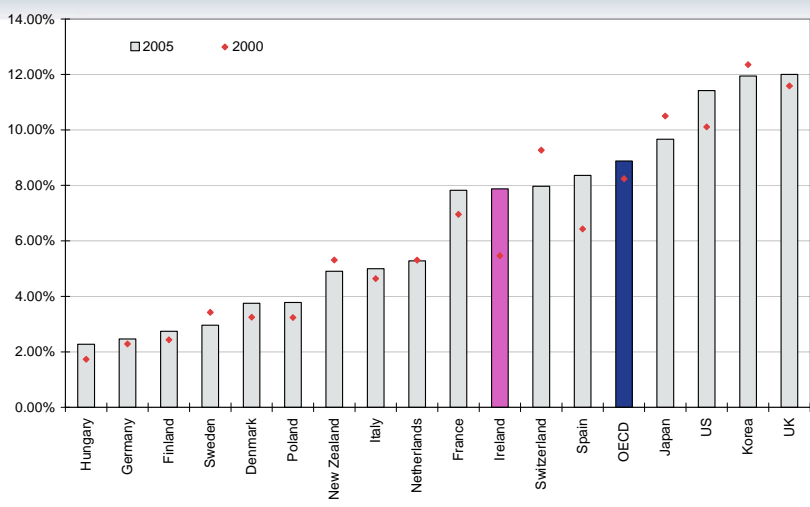


The main source of indirect tax revenues for all countries is a sales or value added tax on consumption. While they are less likely to affect incentives to work or invest, they can be regressive. They can also discourage tourism. Irish VAT rates are amongst the highest in the benchmarked countries.

OECD-28 Ranking: 19 (↓2)

Source: OECD, Tax Database, 2008

Figure 7 Property Tax Receipts (as a % of Total Tax Revenue), 2005

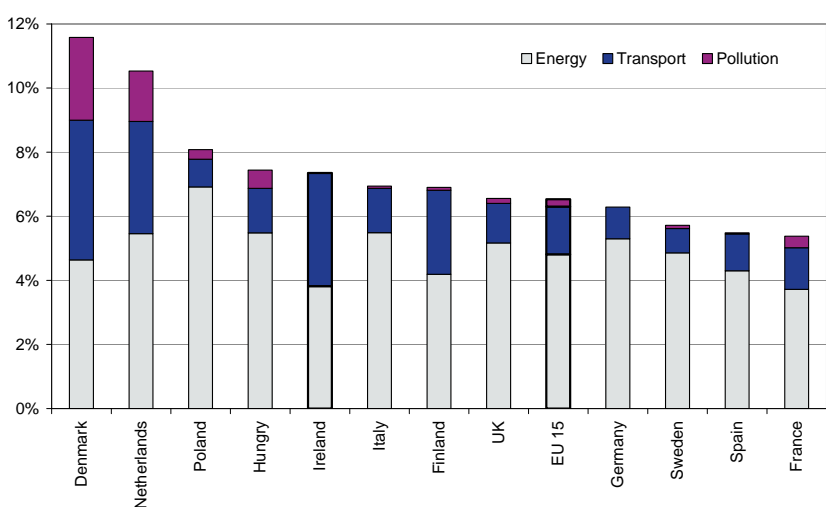


Ireland's tax take from property is close to the OECD average. The major component of property tax revenue in Ireland is stamp duty, which is dependent on property transactions. Other components include capital gains tax and capital acquisitions tax.

OECD-28 Ranking: 10 (↓3)

Source: OECD, Revenue Statistics 1965-2006

Figure 8 Use of Environmental Taxes by Type (as % of Total Tax Revenue), 2005<sup>iv</sup>



Overall, Ireland collects a relatively large proportion of its tax revenue from environmental sources, but Ireland does not tax pollution, as some other countries do. Ireland's share of revenues from energy is also below the EU average.

EU-15 Overall Ranking: 5 (↓2)

Source: Eurostat, Environment and Energy Indicators

## Appendix 2.

### Council Members

Dr Don Thornhill	Chairman
Mr Rory Ardagh	Director, Telecom Property Holdings Limited
Mr Brendan Butler	Director of Strategy, Trade, EU and International Affairs, IBEC
Mr Donal Byrne	Chairman, Cadbury Ireland Limited
Mr Shay Cody	Deputy General Secretary, IMPACT
Mr Martin Cronin	Chief Executive Officer, Forfás
Mr Pat Delaney	Director of Sectors and Regions, IBEC
Ms Annette Hughes	Economist, DKM Economic Consultants
Mr Seamus O'Morain	Assistant Secretary, Department of Enterprise, Trade and Employment
Mr William Prasifka	Chairperson, Competition Authority
Mr William Slattery	Chief Executive Officer, State Street International (Ireland)
Mr Paul Sweeney	Economic Adviser, Irish Congress of Trade Unions
Mr John Travers	Consultant and Former Chief Executive Officer, Forfás
Prof Ferdinand von Prondzynski	President, Dublin City University

### Council Advisers

Mr Paul Bates	Assistant Secretary, Department of Arts, Sports and Tourism
Ms Ruth Carmody	Assistant Secretary, Department of Education and Science
Ms Mary Doyle	Assistant Secretary, Department of An Taoiseach
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Ms Mary Moylan	Assistant Secretary, Department of Environment, Heritage, and Local Government
Mr John Murphy	Assistant Secretary, Department of Transport
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<sup>i</sup> 2006 figures are provisional figures. Rankings incorporate the latest available data for countries that are unavailable for 2006.

<sup>ii</sup> In Ireland, companies in the manufacturing industry had a rate of 10% until the rate changed to 12.5% in 2003. In making international comparisons of corporate tax rates, it is important to take account of the impact of exemptions in the tax base.

<sup>iii</sup> OECD average minus US.

<sup>iv</sup> Rankings incorporate the latest available data for countries that are unavailable for 2005.