TAX EXPENDITURES REVIEW 2017

Tax Strategy Group – TSG 17/13

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TAX EXPENDITURES

1. Introduction

This paper for the TSG on tax expenditures has been driven by an increasing awareness of the important, but often overlooked, role played by tax expenditures as a category within the tax policy sphere.

There has been increased focus on tax expenditures from different perspectives in recent years and more recently in the IMF's report on its 2017 Article IV Consultation with Ireland, which was published on June 26th, 2017. It included a list of factors that the IMF feel should be considered in order to counter what it saw as Ireland's "critical" need to prioritise the use of our limited fiscal space. These factors included the need for a broad and stable tax base, and "In this context, a review of tax expenditures should be considered".

This paper will briefly set out:

- The official policy on tax expenditures
- Defining tax expenditures
- Merits and demerits of tax expenditures
- Evolution of analysis and overview of most significant tax expenditures in Ireland
- The evaluation of tax expenditures
- Conclusions

2. Official policy on tax expenditures

The Government's "A Strategy for Growth, Medium-Term Economic Strategy 2014-2020" [1] sets out a number of principles concerning tax expenditures, stating that the Government will:

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

[1] http://www.per.gov.ie/en/launch-of-a-strategy-for-growth-medium-term-economic-strategy-2014-2020/

3. Defining tax expenditures

Tax expenditures have been broadly defined as the deductions, credits, exclusions, exemptions, and other tax preferences that represent departures from a “normal” tax code.

While there are a number of broadly similar definitions of what constitutes a tax expenditure in use, the Department of Finance’s *Guidelines for Tax Expenditure Evaluation* (published in 2014) draw on the OECD’s definition, and describes a tax expenditure as a transfer of public resources that is achieved by:

a) reducing tax obligations with respect to a benchmark tax rather than by direct expenditure; or,
b) provisions of tax legislation that reduce or postpone revenue for a comparatively narrow population of tax payers relative to the tax base

Defining what is the “normal” or “benchmark” tax code against which the nature and scale of tax expenditures is to be measured is itself difficult, as is placing a boundary on the concept of “a comparatively narrow population”, as all three are open to some interpretation. It is these open-ended aspects of the definition of tax expenditures that has led to an understandable reticence to study them as a classification, rather than on a case-by-case basis where it is much easier to arrive at an agreed definition of the measure being examined.

4. The merits and demerits of tax expenditures

The concept of “tax expenditures” began to develop in the 1960s when the Assistant Secretary of the U.S. Treasury, Stanley Surrey, noted that many tax preferences[2] resemble spending.

Tax expenditures continue to be part of any government’s macroeconomic toolbox, and in some circumstances they can be an effective means of providing incentives to citizens and firms to achieve specific economic, fiscal or social goals. They can benefit from administrative economies of scale and there is no need for the costs of administering substitute programmes. They can also be targeted at specific sectors and can of course be reduced or eliminated as necessary. As the 2009 Commission on Taxation pointed out

> *“*There are valid reasons why a tax system might need to incorporate relieving measures and exemptions…. Such measures, while they may reduce the tax base as compared with circumstances where they did not apply, may reasonably be regarded as part of the structure of the tax system…*”,*

However their impact on the budget tends to be considerably less visible than that of normal expenditures, and they have tended to receive little systematic scrutiny. Tax expenditures can

[2] A US term describing an income or other event that is excluded when calculating one's ordinary tax liability.

be a poor way of pursuing equity in a progressive taxation system, as individuals typically require sufficiently high tax liabilities and therefore sufficiently high incomes to benefit from them, and they often provide no benefit to those not in the tax system. They can be inefficient or poorly targeted or create significant distortions in the market. They can benefit individuals or interest groups and be prone to lobbying where it is often easier to argue for tax breaks than explicit support through direct payments from the Exchequer. It can often be easier to argue for retention of a tax expenditure when the original purpose of a tax expenditure or group of tax expenditures has been served and the economic or social arguments no longer justify its retention. Indeed there is also less incentive for a government to end a tax expenditure, as subsidies and expenditures in the form of tax breaks reduce net tax revenue instead of increasing measured spending.

The downsides of Exchequer subvention can be the limited evaluation of expenditure programmes, the unwillingness to re-allocate expenditure from specific activities and the alignment of public authorities and public expenditure goals with specific interests.

Tax expenditures can therefore perform very much like spending programs, which means they may serve or harm the public depending on whether they serve a legitimate public purpose in the most efficient manner possible. But, as already noted, the identification and measurement of tax expenditures can be imprecise.

Table 1 from a 2014 IMF report (after Villela et al 2010) is a useful comparison between the merits and demerits of tax expenditures compared to direct spending.

Table 1 Comparison of tax expenditures and direct spending

	Tax Expenditure	Direct spending
Accessibility for beneficiaries	Simple, because of their automatic nature	More complex, requiring selection
Administrative and compliance costs	High, if exemptions are properly monitored	Medium due to necessity of selection and allocation system
Possible abuses	Evasion, avoidance and rent seeking	Arbitrariness, inefficiency and capture of the allocating body
Flexibility	Work with permanent laws, thereby generating stability but also inertia	Work with budgets, evaluation and regular reallocations
Transparency and accountability	Their automatic nature does not contemplate control of mechanisms or accountability	Must be approved by legislature, as with all Government expenditure
Expenditure control	Expenditure determined ex-post; uncertain and unlimited which can cause fiscal imbalances	Programmed and controlled spending limited by budget law
Equity	Only potential taxpayers benefit with the highest income often benefits the most	Discretion can provide more equitable access enhancing targeting of beneficiaries

5. Evolution of the evaluation of tax expenditures in Ireland

There has been evaluation on-going of certain tax expenditures in the Department since 2006.

The 2009 Report of the Commission on Taxation, identified 258 tax expenditures. Of the 241 it reviewed, it saw 130 (54%) as part of the benchmark tax system. Of the remaining 111, It recommended that 31 (13%) be discontinued, 33 (14%) modified, and 47 (20%) continued as was.

The Revenue Commissioners' own ongoing list of Tax Expenditures (http://www.revenue.ie/en/about/statistics/costs-expenditures.html), currently provides revenue forgone and numbers utilising/number of claims for 116 expenditures, with data from 2004 up to 2016 (although very little data is available for 2016 as yet). Revenue include

particular items (e.g. personal tax credits) as tax expenditures, whereas the Department of Finance does not, as we consider them part of the "benchmark" system.

The 2009 Commission on Taxation devoted roughly 20 per cent of its report to a review of tax expenditures. Since the publication of that report, the Department of Finance has built on the Commission's work with the report on tax expenditures incorporating the Department's guidelines for Tax Expenditure Evaluation published in October 2014[3]. These guidelines, which were informed by international best practice, represent the framework that the Department's policymakers use when considering whether or not to advise the Minister to introduce a new tax expenditure or in reviewing an existing measure.

In part this was also a response to an EU Budget initiative. Article 14(2) of EU Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States reads:

"*Member States shall publish detailed information on the impact of tax expenditures on revenues.*"

Ireland has also sought to meet this requirement, through the Department of Finance publishing for the last two years (2015 and 2016) an annual Report on Tax Expenditures which incorporates the outcomes of certain tax expenditure reviews carried out in the previous 12 months. A further such report will be published for Budget 2018.

As well as the reviews, each report contains a series of tables which outline the fiscal impact of the range of tax expenditures as required under the EU Budgetary Framework Directive, through providing a list of the extant tax expenditures and where available the number availing and revenue forgone in respect of each of the two most recently available years.

The tables categorise tax expenditures under a number of headings:

1. Capital Gains Tax (CGT)/Capital Acquisitions Tax (CAT)/Pensions
2. Stamp Duty/Deposit Interest Retention Tax (DIRT)/Local Property Tax (LPT)
3. Benefit-in Kind
4. Corporation Tax
5. Excise Duty
6. Value Added Tax (VAT)

[3] http://www.budget.gov.ie/Budgets/2015/Documents/Tax_Expenditures_Oct14.pdf The Tax Expenditure Guidelines set best practice in ex ante and ex post evaluation of tax expenditures. The purpose was that they would be used by policy-makers in Ireland in the future when considering whether or not to introduce a new tax expenditure or in reviewing an existing measure.

7. Personal Tax Credits

6. Overview of the most significant tax expenditures in Ireland

The following figure shows the percentage of the total revenue forgone (€5.3 billion) under nine headings (headings 1 and 2 in the 2016 Report have each been broken into two parts). It should of course be noted that data for quite a few tax expenditures is not available, so the €5.3 billion is an underestimate.

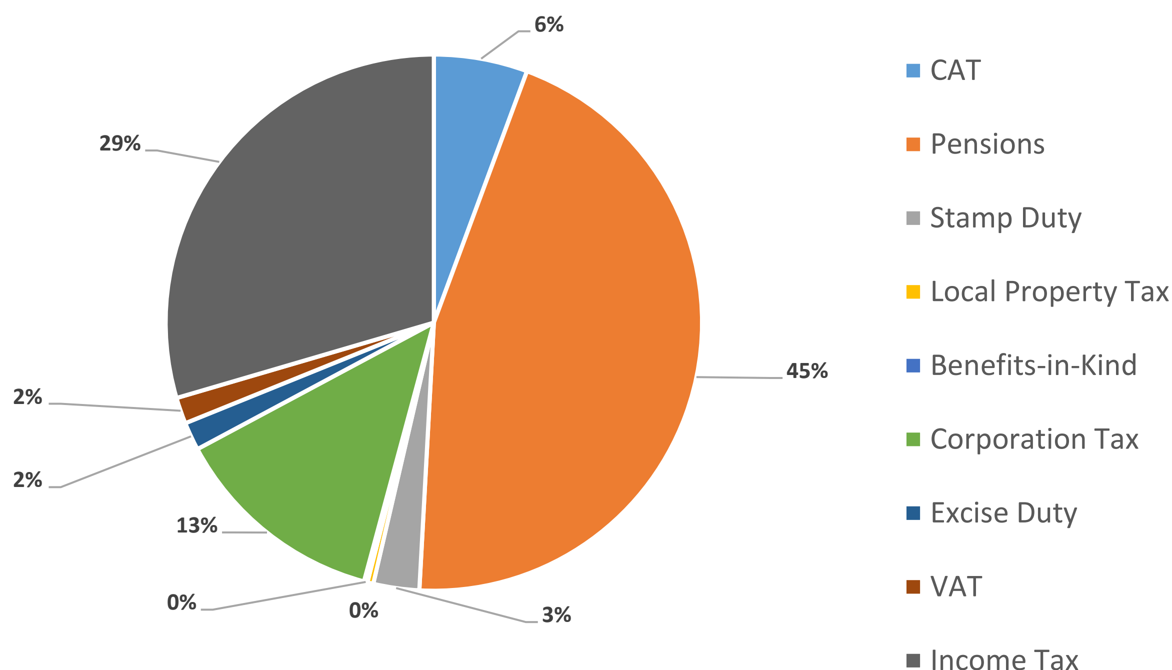
The 2016 version of the Report can be found at:

http://www.budget.gov.ie/Budgets/2017/Documents/Tax_Expenditures_Report%202016_final.pdf

The 2015 version of the Report can be found at:

http://budget.gov.ie/Budgets/2016/Documents/Tax_Expenditures_Report_pub.pdf

Figure 1 : Share of Tax Expenditures by tax head



Source: 2016 Tax Expenditures Report. Figures refer to 2014 or latest year available, and only where revenue foregone figures are available.

The following two tables shows the top ten tax expenditures from the 2016 Report in terms of revenue foregone, and the most expensive tax expenditure under each of the 9 categories. The figures are for the most recent year available, and again the health warning vis-à-vis the

lack of data on quite a number of the tax expenditures included in the Reports should be borne in mind.

Table 2: The most expensive Tax Expenditure in each tax category

Top TE by category	Name	€ million
CAT	CAT agricultural relief	215
Pensions	Exemption of investment income and gains of approved superannuation funds	865
Stamp Duty	Certain company reconstructions and amalgamations	68
Local Property Tax	Exemptions	12
Benefits-in-Kind	Cycle to Work Scheme	4
Corporation Tax	Research & Development (R&D) Tax Credit	553
Excise Duty	Remissions/repayments of VRT	25
VAT	VAT refund to flat rate farmers	54
Income Tax	Medical Insurance Relief	355

Source: 2016 Tax Expenditures Report. Figures refer to 2014 or latest year available.

Table 3: The top 10 Tax Expenditures by cost

	Tax Expenditure	Value €m	Tax Category
1	Exemption of investment income and gains of approved superannuation funds	865	Pensions
2	Research & Development (R&D) Tax Credit	553	Corporation Tax
3	Employees' contribution to approved superannuation schemes	549	Pensions
4	Exemption of employers' contributions from employee BIK	520	Pensions
5	Medical Insurance Relief	355	Income Tax
6	Mortgage Interest Relief	266	Income Tax
7	CAT agricultural relief	215	CAT
8	Pension Contribution (Retirement Annuity, PRSA and QOPP)	210	Pensions
9	Health Expenses	146	Income Tax
10	One Parent Family Tax Credit	142	Income Tax
Total	**Total for the Top 10**	**3,821**	
Total	**Total for all Tax Expenditures**	**5,348**	

Source: 2016 Tax Expenditures Report. Figures refer to 2014 or latest year available.

These Top 10 account for 71% of the total cost of all tax expenditures (for which data are available), and Income Tax accounts for approximately three-quarters of all tax expenditures.

7. Necessary Questions in Evaluation

It is important that before policy decisions are taken, the case for a particular tax expenditure is carefully reviewed and that it can stand up to scrutiny. Just as important is the need to regularly review existing tax breaks to make sure that they remain relevant and are achieving the purpose for which they were intended.

The *2014 Guidelines for Tax Expenditure Evaluation* provided the key questions which should structure any given tax expenditure evaluation (see Table 4). These questions were chosen following an extensive review of the tax expenditure evaluation literature and international evidence.

Table 4: Key Questions for Tax Expenditure Evaluation

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

Source: Guidelines for Tax Expenditure Evaluation, Department of Finance (2014)

Table 5 outlines how the scope of any evaluation should be proportionate to the size of the tax expenditure.

Table 5: Levels of Evaluation

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

Source: Guidelines for Tax Expenditure Evaluation, Department of Finance (2014)

Prior to a new tax expenditure being introduced, a number of key questions should be addressed in an ex ante evaluation.

Firstly, clarity is required as to the objective of the tax expenditure, as without a clear objective it will be impossible to evaluate it. Secondly, it should be clear what market failure the tax expenditure is addressing. Market failure refers to a situation where the economic choices of households and firms leads to an under or over-production of a good (from the point of view of maximising the welfare of society as a whole). When considering market failure, it is also important to judge whether a tax expenditure is the best public policy tool to address the problem, as in some cases direct expenditure or regulation could be more effective. The likely cost should also be established prior to a new measure's introduction and a view formed as to its potential impact.

All tax expenditures should be reviewed every three to five years, depending on their cost. During a review (ex post evaluation), it is important to consider whether the tax expenditure is still relevant. Similar to ex ante evaluation, its cost will also need to be addressed. The question of the impact of the tax expenditure is particularly important at the ex post stage. Finally, the efficiency of the tax expenditure is crucial to consider. Efficiency is an economic concept that implies resources are well allocated such that nobody can be made better off without making someone else worse off. An inefficient tax expenditure implies that the foregone tax revenue has not resulted in as much additional economic activity compared to alternative interventions. This is often because the tax expenditure carries deadweight, which means that the foregone tax revenue is financing economic activity that would have occurred anyway in the absence of a tax expenditure.

In any type of evaluation, the scope should be proportionate to the size and objectives of the tax expenditure. Large tax expenditures (defined by the *2014 Guidelines* as those costing over €50 million per year) require a more detailed assessment than small ones (those costing less than €10 million per year).

Two examples are included here of such evaluations.

Case Study 1: Ex Ante Evaluation of Tax Relief for Trade Union Subscriptions and Professional Body Fees (2016)

The evaluation of trade union subscriptions and professional body fees produced for the 2016 Tax Expenditures Report is an example of an ex ante evaluation conducted by the Department. These are tax expenditures associated with income tax, with the former abolished in 2011 and the latter partially restricted. They were reviewed in 2016 as part of a commitment made in Budget 2016. The tax relief for trade union subscriptions previously cost

€26 million at its peak, which, according to the *2014 Guidelines*, requires a medium level of assessment as a result.

The evaluation discussed the objective of re-instating the trade union subscription income tax relief. While it would provide a refund of income tax for people that are members of a trade union, it was not clear what specific Government policy objective it would meet.

On the issue of market failure, the evaluation could not identify one. There was no evidence to suggest that current trade union subscription rates were a disincentive to join. Given this, the evaluation judged that a tax expenditure was not the best course of action to take.

Nevertheless, the evaluation still provided an estimate of the cost of the scheme. Assuming it was introduced in a similar way to previously, and given the latest available data on union membership, it estimated that it would cost €39.5 million per annum, which would still leave it classified as a medium-level case for evaluation in the 2014 Guidelines.

In reaching its conclusions not to re-instate the relief, the evaluation noted the considerable level of deadweight that would likely occur. When a broad-based scheme is introduced, which does not have a considerable impact on behaviour, it is to be expected that the deadweight will be large.

In summary, this case-study provides an example of a recent tax expenditure that failed to meet the requirements as set out by the *2014 Guidelines.* By providing a framework for evaluation, the weaknesses of the proposed tax expenditure were clear.

Case-study 2: Ex Post Evaluation of the R&D Tax Credit (2016)

The evaluation of the R&D tax credit in the 2016 Tax Expenditures Report is an example of a recent large ex post evaluation conducted by the Department of Finance. The R&D Tax Credit is one of the few corporation tax reliefs available in Ireland. The Tax Credit provides a 25% credit for qualifying R&D. For every €4 of R&D conducted by a firm, they can reduce their corporation tax liability by €1 (or apply for a tax credit refund when their tax liability is less than the value of the credit). The R&D tax credit was reviewed as part of a regular review process for large tax expenditures, in line with the Department of Finance's *2014 Tax Expenditures Guidelines.* The last review was undertaken in 2013 and it was found that the tax credit was an effective means of encouraging R&D at the time.

The 2016 evaluation found that the tax credit continues to be a relevant tax expenditure due to the importance of R&D in stimulating innovation, which in turn is a key driver of productivity and long-run economic growth. Private firms under-invest in R&D due to its risky nature and so, from the perspective of the social optimum, government intervention remains warranted.

The tax credit was judged to have had a strong impact as new firms had begun R&D since its introduction, and other firms had increased their level of R&D activities.

With regard to its efficiency, the evaluation employed a treatment and control group framework in order to estimate the level of R&D activity that was due to the tax credit (as opposed to R&D that would have occurred anyway). This type of framework, which relied on corporation taxpayer data from the Revenue Commissioners, is considered to be one of the most robust ways of evaluating a tax expenditure.

Overall, the evaluation found that the tax credit was responsible for 60% of the R&D conducted by firms since 2009. This was judged to be a reasonable level of additionality although the fact that 40% of observed R&D would have occurred in the absence of the credit indicates that the scheme has notable deadweight associated with it. In the case of a corporate tax expenditure, which is open to all firms, a certain level of deadweight is impossible to avoid.

Overall, this particular review used the evaluation questions provided for in the *2014 Guidelines* to present a detailed and evidence-based assessment of the R&D tax credit. Without regular evaluations such as these, policymakers will be unable to determine if tax expenditures make a difference and represent value for money. Regular evaluation is particular important when the cost of a tax expenditure increases substantially over time, as is the case with the R&D tax credit.

8. Data and Methodological Limitations in Evaluations

Following the economic and fiscal crises, there was increased demand for a more rigorous evidence base to underpin policymaking, not least to address the deficiencies in policymaking exposed by the crises. This applied in tax policy as much as in other areas. In the specific area of tax expenditure evaluation, there has been an expansion in output by the Department of Finance.

Despite this development, evaluations can frequently be hampered by data limitations. Often it is difficult to gather the relevant data on a specific tax relief or in other instances data may simply not exist. For example, the 2015 ex post evaluation of the Artists' Tax Exemption was unable to fully quantify the benefits of the scheme as it relates to a cultural output.

It is often also quite difficult to establish a counterfactual scenario in an ex post evaluation. Identifying or modelling what outcomes would have occurred in the absence of a particular tax expenditure is key to determining its impact and level of efficiency. However, this is often difficult to do due to a variety of reasons. Broad-based tax expenditures can mean that no comparison can be made between two otherwise similar groups whose key difference is that one uses the tax expenditure and one does not. In the case of the R&D tax credit, for example, the tax expenditure is open to all firms who file a CT1 return with the Revenue Commissioners. All firms who conduct R&D will use the tax credit so there is no unaffected group from whom a comparison can be drawn. The 2016 evaluation therefore had to exploit a historical policy change to the tax credit in order to create two otherwise similar groups for comparison.

Arguably other areas of public policy may find it easier to identify counterfactuals when performing an impact assessment, as trials or pilots may be easier to conduct. But in the area of tax policy, designing a tax expenditure which favours one group over another very similar group for the purposes of ensuring a robust evaluation would run into ethical and State Aid concerns.

Data limitations can often force changes in methodological approaches. The 2013 review of the R&D tax credit attempted a particular evaluation approach which tried to model the cost of R&D to a firm, but financial data constraints meant that the approach was unsuccessful. Therefore the 2016 evaluation used an alternative treatment and control group methodology in order to identify impact and efficiency.

The carrying out of an ex ante evaluation, as suggested by the *2014 Guidelines,* is a useful exercise for identifying what data will be required in the ex post evaluation. For example, the ex ante evaluation of the Knowledge Development Box (KDB) in the 2015 Tax Expenditures Report provided direction on the data that would be required in future. This has proven useful to the Department in its preparations for this future evaluation.

There is a balance that must be judged in asking the Revenue Commissioners or other stakeholders to gather more data on tax expenditures. On the one hand, more information will assist in any evaluation but the potential addition to the administrative burden of the taxpayer must also be considered. In the case of the most expensive tax expenditures, however, it seems reasonable to consider targeted data expansion where key information gaps have been identified.

9. Future work and conclusions

In terms of future developments it is worth highlighting a number of issues which might be considered by the TSG.

There have been significant advances made in terms of the analysis of tax expenditures and the development of an analytical process for such evaluation, whether it is ex ante or ex post evaluations. This has built on the work of the 2009 Commission on Taxation. As part of a broader enhancement to the evidence base available to the Department to inform taxation policy since 2009, a comprehensive evaluation structure is now in place for such reviews. The Department now routinely carries out reviews of existing tax expenditures and ex ante evaluations of proposed new tax incentives. Many of these are published (in full or in summary) in the now annual Report on Tax Expenditures. This provides the benefit of more immediate and timely analysis compared to the systematic and detailed analysis that arises with once-in-a-generation Commissions on Taxation.

Changes to tax expenditures are considered to be discretionary revenue measures. Discretionary tax measures, which form the bulk of discretionary revenue measures, are highly relevant in the context of EU fiscal surveillance. A discretionary tax measure can be

broadly defined as any legislative or administrative change in policy that has an impact on tax revenues, whether it is already finally adopted or only likely to be implemented.

The availability of sound estimates of discretionary tax measures is paramount for an appropriate assessment of the government fiscal stance. In particular, the reformed Stability and Growth Pact (SGP) envisages a specific role for discretionary revenue measures both in the preventive and in the corrective arm. Therefore, a rigorous implementation of the SGP requires an assessment of the magnitude of discretionary revenue measures.

A renewed and increased emphasis on the evaluation of existing and proposed tax expenditures combined with the intention to close off those which do not serve their original intention could increase the fiscal space over time.

Of course the difficulty is always what tax expenditures to select for consideration. Table 3 indicates that the top 10 tax expenditures account for 71% of the total cost of all tax expenditures (for which data are available), and Figure 1 indicates that Income Tax accounts for approximately three-quarters of all tax expenditures. The options for reducing or eliminating such expenditures may be low. This is particularly the case given the large number of beneficiaries of such expenditures. There may be smaller tax expenditures by cost but the difficulty of reducing them or standardising them should not be underestimated.

Previous sections of this paper presented the reasons when a tax expenditure may be appropriate (e.g. market failure), the Department's evaluation framework (i.e. the *2014 Guidelines*) and gave further detail on existing tax expenditures and particular examples of recent evaluations. In light of this, an issue which might be considered by members of the Tax Strategy Group is whether there are specific tax expenditures which might be considered for analysis for this or for future Budgets. It is important that there is adequate consideration of the most important tax expenditures to be analysed so that resources can be devoted appropriately and outcomes achieved.

Bibliography

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