



COMMISSION ON TAXATION
AN COIMISIÚN UM CHÁNACHAS

PART 2

INTRODUCTION



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Part 2: Introduction

Section 1: Establishment and terms of reference

The Commission on Taxation was established on 14 February 2008 to review the structure, efficiency and appropriateness of the Irish taxation system. In setting up the Commission, the Taoiseach (then Tánaiste and Minister for Finance), Brian Cowen, T.D., indicated that its work would help establish the framework within which tax policy would be set for the next decade at least, and that it was important that it took a strategic, considered and balanced perspective that recognised the evolving challenges ahead.

The terms of reference for the Commission were far-reaching. We were asked to have regard to the commitments on economic competitiveness and on taxation contained in the Programme for Government, in particular the four commitments:

- To keep the overall tax burden low and implement further changes to enhance the rewards of work while increasing the fairness of the tax system
- To ensure that our regulatory framework remains flexible, proportionate, and up-to-date
- 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, and
- The guarantee that the 12.5% corporation tax rate will remain

We were invited, in the context of maintaining an equitable incidence of taxation and a strong economy, to consider the structure of the taxation system and specifically to:

- 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
- Consider how best the tax system can encourage long term savings to meet the needs of retirement
- Examine the balance achieved between taxes collected on income, capital and spending
- 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
- Consider options for the future financing of local government, and
- Investigate fiscal measures to protect and enhance the environment including the introduction of a carbon tax

In our terms of reference, we were requested to report by 30 September 2009. Following on from discussions between our Chairman and the Minister for Finance, Brian Lenihan, T.D., in March 2009 we agreed to bring forward our reporting date to 31 July 2009.

Section 2: Approach adopted

2.1 Meetings, subgroups, plenary sessions

We held our inaugural meeting on 5 March 2008 and 32 plenary meetings were held between April 2008 and July 2009. Having regard to the broad terms of reference, the short timescale and the size and composition of the Commission, we agreed at the first meeting that the most effective way of organising the work would be to establish a manageable number of subgroups to focus on specific aspects of our terms of reference. Plenary meetings considered the more general issues as well as the reports from the subgroups on the work allocated to them.

Accordingly, seven subgroups were established to consider certain specific topics mentioned in the terms of reference as follows:

- How best the tax system could encourage long term savings to meet the needs of retirement
- Options for the future financing of local government
- Fiscal measures to protect and enhance the environment including the introduction of a carbon tax
- Review of 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
- How best the tax system can support economic activity and promote increased employment and prosperity
- The issues around maintaining an equitable incidence of taxation
- The balance between taxes collected on income, capital and spending and providing the resources necessary to meet the cost of public services and other Government outlays in the medium and longer term

The subgroups met a wide range of interested parties in the course of preparing their reports. In total the subgroups held over 100 meetings.

2.2 Submissions

We decided at the outset that written submissions received by us would be an important source of views for us in fulfilling our mandate. They would also provide interested parties with an opportunity to make proposals on one or more of the topics covered in the terms of reference. There had been considerable interest in the work of the Commission, as this was the first substantial review of the tax system in over 25 years.

Advertisements inviting submissions were placed in the national press and some 175 replies were received. A list of those who made submissions is provided in Annex 3 of our Report.

2.3 Oral hearings

We invited 12 organisations which made submissions to attend oral hearings in support of their written proposals where we considered the issues covered in their submissions could be usefully

explored further and were necessary for our deliberations. The oral hearings took place from 23 February to 25 February 2009. A list of those who attended oral hearings is in Annex 4.

2.4 Other consultations

We consulted widely with a large number of interested parties, in both the private and public sectors, to help us in our deliberations. Details are in Annex 4.

Section 3:

Principles in the reform and design of the tax system

3.1 Introduction

We established a set of guiding principles – comprising both general principles of taxation (such as equity) and operational principles to help us in our work (such as adopting an evidence-based approach) that would guide us in fulfilling our mandate. The principles, which were developed having regard to our terms of reference, are as follows.

3.2 Principles of taxation

3.2.1 Equity

Equity is a key aspect of a tax system. Equity means taxing persons on their ability to pay. Our terms of reference invited us to consider the structure of the tax system in the context of *maintaining an equitable incidence of taxation*. We are also asked to have regard to the commitment contained in the Programme for Government to increase *the fairness of the tax system*. One of the difficulties with equity is that it means different things to different people.

Equity is generally broken down into two components, horizontal equity and vertical equity.

- **Horizontal equity:** The concept of horizontal equity suggests that two persons with the same income should pay the same amount of tax. However, if they are not in equal positions because say, one person is a lone parent, the equity principle may also suggest that the tax burden of the single parent should be reduced. This raises questions as to the appropriate amount of the reduction and the documentation required by the tax authorities to justify eligibility for a reduction, and illustrates a core dilemma in the design of a tax system: equity and simplicity may be in conflict with each other¹.
- **Vertical equity:** The concept of vertical equity suggests that the tax burden should be distributed fairly across persons with different abilities to pay. Persons with higher income should pay more in taxes than persons with lower income. A progressive tax takes a higher percentage of income as income rises, so that high earners pay a higher proportion of their incomes than low earners.

Taxes that are not progressive may be either proportional (sometimes called “flat”) or regressive. A flat or proportional tax, which takes the same percentage of income from each taxpayer, does

¹ Horizontal equity is also relevant in an EU context, where the principle that resident and non-resident taxpayers in similar situations carrying out similar transactions should be subject to similar taxation treatment, is well established.

not, in general achieve vertical equity. It may, on the other hand, be highly efficient to implement. A regressive tax takes a smaller percentage of income as income rises — poor people pay a larger fraction of their incomes in taxes than rich people. This does not achieve vertical equity.

Equity is relevant not only to income disparities but also to the treatment of sectors of society with particular needs and to life consumption and savings patterns. The tax system (and fiscal policy through direct expenditure) to some extent addresses variations in life consumption patterns through, for example, the provision of mortgage interest relief for first-time buyers and enhanced tax relief for pension provision for individuals as they get older. We have, however, noted provisions in the tax code that unreasonably favour particular categories of taxpayer and we deal with these in our Report. Such provisions are not consistent with equity.

Equity must, however, be considered in the context of the overall tax system. A lack of progressivity in one area of the system may be compensated for by having a high degree of progressivity in other areas, or by focused direct expenditure – which, of course, is financed from tax revenues.

Rates of tax are also relevant to equity in that they enhance the progressivity of the tax system. While the introduction of a third rate of income tax could increase progressivity, there is a need to strike the appropriate balance between progressivity on the one hand and the impact on the incentive to work and enterprise on the other. It is of course also arguable that, looked at solely from the point of view of encouraging economic growth, a flatter system would be preferable. These are tensions that we have encountered during our discussions.

3.2.2 Flexibility

All societies change over time. So do markets, business practices, technology and economic conditions. A flexible tax system is one that is responsive to and capable of changing in line with these factors. For example, electronic commerce transformed the global economy from the late 1990s onwards, and tax systems worldwide had to adapt to the new types of transactions that emerged.

Flexibility may also be looked at in the context of budget volatility and the ability to raise one tax to compensate for a shortfall in another tax. This raises the question of over reliance on particular areas to provide a revenue stream versus having a broader base, and was something that we consider in the context of the balance of taxes topic in Part 4 of our Report.

The interaction between flexibility and the stability that is required for business was also looked at by us – a tax that has too much flexibility may create uncertainty for businesses and individuals.

We were asked in our terms of reference to have regard to the commitment in the Programme for Government that the regulatory framework should remain flexible, proportionate and up to date. We considered this aspect of flexibility also.

3.2.3 Tax neutrality

In a general sense, tax neutrality is used to describe a tax system that does not create a bias that could influence a taxpayer to choose one course of action over another. In other words, decisions are made on their merits and not for tax reasons.

As specific measures can be incorporated into the tax system to provide for, or to depart from, tax

neutrality in order to achieve a particular policy goal such as encouraging economic activity, we considered that the adoption of tax neutrality as a general principle without qualification would unduly hinder our consideration of options. Instead, ways that the tax system approximated to or departed from tax neutrality were examined in the course of our deliberations, as this allowed us to focus on the efficacy of different measures.

3.2.4 Simplicity

The simplicity principle requires that the tax rules are known and that liability is clear. It implies that the tax system is comprehensible and rational: in other words, one where the tax base is certain and where the tax rules are clear and easily understood, so that the taxpayer can anticipate in advance the tax consequences of a transaction.

The regulatory burden caused by taxation requirements covers the time and cost of the administration associated with compliance – such as making returns or keeping records that would not otherwise be required by the company or the individual concerned. It also includes the work needed in becoming compliant with a tax rule – such as putting appropriate technology, practices and procedures in place.

In adopting simplicity as a core principle, we considered the regulatory burdens of any new taxes, or changes to existing taxes, that we proposed. The terms of reference asked us to consider how best the tax system could support economic activity, and we considered that having logical, intelligible tax rules should be part of these considerations.

In a business context, the regulatory burden falls disproportionately on small and medium-sized enterprises (SMEs). Proposals to reduce the regulatory burden are addressed in Part 5.

3.3 Operational principles

3.3.1. Evidence-based approach

Our adoption of an evidence-based approach meant that, wherever available, facts and appropriate benchmarks were used to support our analysis and our conclusions.

3.3.2. Pragmatism

We have had 16 months in which to complete our deliberations. This tight timeframe and the nature of our terms of reference, suggested that we should for the most part focus on reviewing the current tax system rather than designing a new one. The obvious exceptions here were carbon tax, property tax and domestic water charges as these are not currently features of the Irish tax system. Other areas of the tax system were evaluated in the context of the existing structures and range of taxes. A more extensive analysis of the Irish tax system might, for example, examine whether progressivity in direct taxation is best provided mainly through the income tax system, whether taxing total income rather than consumption expenditure is appropriate and whether Ireland's tax system is optimal by reference to norms in other countries. Other tax system models are possible but our consideration of these was necessarily constrained by our reporting timeframe.

Adopting a pragmatic approach also meant that proposals considered by us were tested for viability. Tax policy in Ireland operates within an EU and international framework, and we

considered the impact of this framework and its implicit constraints at the outset – further detail is provided in Section 4 of this Part.

The need to take a strategic, considered and balanced perspective required our proposals to be grounded in reality and to be implementable with a quantifiable impact on Exchequer revenue.

3.4 Interaction between principles and other yardsticks

The guiding principles listed above – equity, flexibility, neutrality, simplicity, an evidence-based approach and pragmatism – interact with each other in complex ways. While dealing with the conflicting demands imposed by the principles proved to be a challenging task, we felt that these principles best provided the guidelines needed in undertaking the tasks specified in our terms of reference.

We also considered other criteria in the course of our deliberations. For example, the ability of the tax system to raise enough money to pay for a given level of public expenditure is central to the terms of reference, and raised issues such as the stability and predictability of the tax base and its overall magnitude. In addition, the polluter pays principle – where the polluting party pays for the damage done to the environment – featured in the discussions on the environmental taxes (see Part 9) and local government financing (see Part 11).

Section 4: International obligations and the tax system

4.1 Introduction

There are overriding principles in the EC Treaty that prohibit discrimination and restrictions on the so-called fundamental freedoms – i.e. the prohibition of discrimination based on nationality and the ability of goods, services, capital and labour to move freely within the internal market. There are also European Union (EU) directives – on direct, indirect and capital taxes – that apply in Ireland. While direct tax falls within the competence of Member States, that competence must be exercised in accordance with EU law. Ireland must also meet its obligations under double taxation treaties and other international agreements. Any proposals for change contained in our Report must be implemented in a manner that is consistent with those obligations.

4.2 EC Treaty basic principles

The principle of free movement of goods is set out in Title I of the Treaty. The principles of free movement of persons, services and capital are set out in Title III.

Free movement of goods (Articles 23 – 31): The free movement of goods is one of the cornerstones of the internal market. Articles 28 to 30 prohibit Member States from imposing or maintaining quantitative restrictions on imports, exports and goods in transit and all measures having equivalent effect (i.e. intra-Community trade barriers), except in special circumstances.

Free movement of persons (Articles 39 – 42): Discrimination based on nationality between workers of the Member States as regards employment, remuneration and other conditions of work and employment is prohibited. A number of directives and regulations have been developed (since 1968) to promote this principle – for example, co-ordination of agreements on social

security, and on visas, residence and work permits across Europe.

Freedom of establishment (Articles 43 – 48): Restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State, or on the setting up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State, are prohibited. Freedom of establishment includes the right to take up and to pursue activities as a self-employed person and to set up and manage companies in any of the Member States. Companies formed under the law of a Member State and with their registered office, central administration or principal place of business in the EU are treated the same way as individuals who are nationals of Member States.

Freedom to provide services (Articles 49 – 55): Restrictions on the freedom to provide services in respect of nationals of Member States who are established in a Member State other than that of the person for whom the services are intended are prohibited.

Free movement of capital and payments (Articles 56 – 60): Article 56 provides that all restrictions on the movement of capital between Member States and between Member States and third countries are prohibited. Restrictions on payments between Member States and between Member States and third countries are also prohibited. Article 58 provides for some limitations on Article 56 and allows Member States to distinguish between taxpayers who are not in the same situation with regard to residence or place where capital is invested. It also allows Member States to take measures to prevent infringements of national laws or to take measures which are justified on public policy or security grounds. However, while Article 58 allows different tax treatment of residents and non-residents and of domestic and foreign-sourced capital, the European Court of Justice (ECJ) has tended to interpret the provision narrowly.

If a conflict arises between Community law and a law of a Member State, then Community law prevails – in this regard, the role of the ECJ in striking down provisions of EU Member States' tax systems that are incompatible with the EC Treaty has become more evident in recent years.

4.3 Compatibility with state aid rules

Tax measures must not only conform to the principle of non-discrimination and the fundamental Treaty freedoms, but also need to be in line with Community state aid rules. Article 87(1) of the EC Treaty provides that "...any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market". There are, however, a number of exceptions to this. For example, aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment may be considered to be compatible with the common market.

4.4 Other international obligations

In Ireland, international treaties take precedence over domestic law. Ireland has concluded a significant number – 46 in force and a further five signed – of double taxation treaties with other countries, primarily drafted by reference to the OECD Model Tax Convention with respect to taxes on Income and on Capital. The purpose of double taxation treaties is to allocate taxing rights

between the contracting States in order to avoid double taxation and to prevent fiscal evasion.

Other international law which is relevant to Irish tax includes the European Convention on Human Rights² and Kyoto Protocol to the UN Convention on Climate Change.

Section 5: Our approach to tax reform

5.1 Role of a tax system

The primary role of a tax system is to raise revenue to fund government expenditure - for day-to-day spending and capital projects. Where expenditure is met through borrowing, tax revenue will be needed to meet the financing costs of such borrowing as well as its repayment. Other roles of a tax system are redistributing income and wealth, deterring certain activities and promoting enterprise and employment.

The Irish tax system has evolved over time to reflect changing economic and social conditions and will need to be equally responsive to new developments in the future. It will, for example, play a role in dealing with Ireland's changing demography, a different environmental context and globalisation of markets. Some of these feature in our Report. In general, we consider that many aspects of the tax system work well and do not require reform. Other areas are in clear need of reform and are the main focus of the proposals in our Report.

5.2 Broaden the base rather than increase the rates

We do not seek to increase the overall levels of taxation. Rather, we set out to broaden the tax base. Having multiple tax sources allows tax revenue to be raised from a wider range of sources and having a broad tax base enables rates of tax to be kept as low as possible, minimising the economic efficiency cost of taxation³. Thus it is our view that lower tax rates on a broad base are better than higher rates on a narrow base. A new tax on property offers the opportunity to reduce the burden of taxation on labour and on economic activity and a new carbon tax has environmental benefits.

Ireland is a small open economy. This means that the economic factors of production are likely to be more mobile and thus they will be more responsive to changes in taxation. Therefore the imperative to broaden the tax base so as to achieve lower tax rates is heightened. Broadening the base includes both extending the base of existing taxes and introducing new taxes on different bases.

Increasing rates of tax on the other hand would be likely to result in behavioural change with a negative impact – for example increased income taxes could be a disincentive to work and a barrier to business growth and job creation. Increased indirect taxes would lead to further adverse effects on cost competitiveness. Higher tax rates are also likely to result in an increase in tax evasion and avoidance.

Of central importance to our approach is positioning the tax system to support economic activity because increased economic activity has the potential to increase employment and thus enhance living standards for all.

² Enacted in Irish Law as the European Convention on Human Rights Act 2003

³ On the importance of lower tax rates, which can achieve the same level of tax revenue with a broader tax base, see 'Taxation and Economic Efficiency', A.J. Auerbach and J. Hines Jr., in 'Handbook of Public Economics, volume 3', A. J. Auerbach and M. Feldstein (ed.), 2002, and 'The Challenge of Tax Reform and Expanding the Tax Base', J. Poterba, The 2009 ESRI Geary Lecture, May 2009.

5.3 Provide a stable revenue base

We consider an important attribute of a tax system is its ability to provide a stable base for tax revenue. This implies that the tax system should be designed with a view to minimising the volatility of tax receipts so that resources required for public services can be provided in a stable way. This implies that tax should be levied in a variety of ways, not all of which need necessarily be correlated with the economic cycle.

5.4 Transitional arrangements

The package of measures that we propose in our Report constitutes structural changes to the taxation system to make it more efficient and equitable in the medium term. The timing of the implementation of these measures is a matter for Government. However, we believe it is important that not all the policy changes would occur at the same time. The phased implementation of these recommendations will need to take account of their interrelated nature and their differing tax administration requirements.

