

# IBEC Submission to the Commission on Taxation

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# Executive Summary

## Introduction

IBEC welcomes the establishment and work of the Commission on Taxation and the opportunity to make this submission. Our submission addresses all of the Terms of Reference items set out by the Commission and outlines the views of IBEC's members in relation to changes required in the Irish taxation system. IBEC would be happy to examine these issues in further detail with the Commission if required.

## Key recommendations

### Optimum tax structure and mix

- IBEC believes that Ireland's relatively low tax burden has been central to its recent economic prosperity and would not support substantive changes to the overall tax burden or mix
- The Commission should examine in detail the principle of hypothecation in the Irish tax system. In particular, IBEC strongly advocates the hypothecation of fuel and energy taxes towards support for energy efficiency measures
- In order to maximise economic growth the Commission should take full account of the implications of globalisation and its impacts on different areas of taxation. It should recognise that increasing taxes on the most mobile factors of production (corporations and labour) will be most damaging to economic growth
- The Commission should recognise that while Ireland has a low income tax burden, this predominantly relates to low and middle-income earners. For those on above average earnings, the tax wedge in Ireland is about the same as the OECD average. The Commission should recommend changes to the income tax system aimed at retaining and attracting high-skilled mobile labour
- Ireland's current corporate tax rate should be protected and its overall corporate tax offer enhanced in order to ensure that it remains an attractive location for increasingly mobile corporate investment
- Consumption taxes should not be increased on any products

### Tax and savings

- The voluntary occupational pensions model in Ireland has worked relatively well to date and substantive changes should not be made to it. Support through the tax system for occupational and personal pensions should be maintained
- Equal incentive (tax plus direct Exchequer contribution) should be provided to all income earners to provide for a pension
- Voluntary phased retirement should be embraced and rewarded. Those who choose to work beyond the standard retirement age on either a part-time or full-time basis should benefit from improved tax credits. Employees remaining in work after the standard retirement age should be allowed to postpone their state pension entitlements for a period and subsequently benefit from increased pension payments
- More flexible pensions products should be examined which would provide savers with access to their funds prior to retirement through a sliding scale of tax relief clawbacks

### Tax expenditures

- Rigorous quantitative assessments on all tax reliefs should be carried out regularly
- In addition to the socio-economic benefits associated with tax reliefs, in cases of mobile investment particular focus should be placed on changes to similar schemes in other countries
- The R&D tax credit scheme must be improved if Ireland is to develop as a world class industry-led location for R&D

- The Film Relief scheme requires further improvements in order to remain competitive with similar schemes now available in other jurisdictions
- The cap introduced on tax reliefs should be amended in order to exclude charitable and philanthropic donations

#### **Local Government financing**

- Improved national oversight and reporting mechanisms are required for the entire local Government sector so that more accurate projections for revenue and expenditure by programme area can be developed
- The budgeting system needs to be improved so that both local authorities themselves and businesses have more certainty in relation to changes to charges and costs
- The Commission should recommend to Government in the strongest possible terms that urgent broadening of the local Government tax and charges base is required
- User water charges must be extended to all users, while rates should also be extended to include all non-household premises, irrespective of ownership
- The Commission should examine a potential phasing in of annual tax charges on immovable property, taking into account the principle that this is the least economically damaging approach to increasing tax revenues

#### **Tax and environmental objectives**

- Given the very challenging 2020 climate change targets which exist for Ireland, IBEC recognises the need for action. A full suite of measures will be required, including much higher priority afforded to energy efficiency, deployment of low carbon/energy efficient equipment, and under certain conditions, an economy wide price for carbon.
- Several policy options exist to put a price on carbon. Some or all of these will likely be new taxation measures and therefore must, as with all proposed climate measures, be subject to a full cost-benefit and regulatory analysis by the Technical Advisory Steering Group. Measures should be prioritised and implemented in a sequence based on least cost.
- Revenues arising from pricing carbon must be hypothecated and returned in the form of reduced labour taxes and as incentives to improve energy efficiency.
- Any carbon taxation measures must be carefully evaluated in order to ensure that they are integrated with and complementary to the objectives of the current tax system.
- If a carbon tax has been evaluated as the most economically efficient policy option once integrated with existing taxation measures and ensuring that it is hypothecated, then it must be designed on the principles of exclusion of the ETS sector, competitiveness, revenue neutrality, equity, simplicity, proportionality and certainty.

# 1. Introduction and background

## 1.1 Appraisal of Ireland's recent taxation policy

The many appraisals of the origins of Ireland's economic recovery in the 1990s generally conclude that there were a number of factors involved. Tax reform, however, is always mentioned as a significant contributor. In an effort to fund Ireland's fiscal excesses of the 1970s and growing Exchequer deficits in the 1980s, a series of tax rate increases were implemented. None were successful in yielding sustainable improved tax revenues but succeeded only in depressing economic activity. With the commencement of social partnership in 1987 it was recognised that Ireland's tax system had become a major impediment to entrepreneurship and the incentive to work. Since then, the transition to lower taxes on investment, enterprise and labour has helped transform Ireland's economy. Ireland's taxation policy has been largely sound over the past decade or so but has not been without its faults.

Viewed in an international context, there are some key features which distinguish Irish taxation policy from that in most other developed countries. Ireland now has the lowest income tax burden in the OECD, some of the lowest tax rates for corporations and investment returns but has relatively high consumption taxes. This model of placing low taxes on the most mobile of capital and relatively high taxes on the less mobile activity of consumption has proved very successful. International research continues to largely endorse the Irish approach to the tax mix and a number of countries have followed Ireland's lead in recent years. This is particularly evident in the area of corporation tax rates where average rates in developed countries have fallen substantially over the past decade or so. There is also a growing acceptance in many countries that a shift in the tax burden from labour to consumption has a positive impact on economic growth e.g. changes to German VAT rates in 2007. Ireland tackled the redistributive challenges associated with relatively high consumption tax, by placing a zero VAT burden on many non-luxury goods.

Despite the reductions in tax rates over the past decade, tax revenues as a percentage of GDP continued to increase as growth accelerated. While the total tax burden in Ireland is lower than the OECD and EU average, there are a number of countries with lower tax burdens<sup>1</sup>. In nominal terms Ireland's tax revenues have also experienced exceptional growth over the past decade with total revenue in 2007 at €47 billion, an increase of almost 300% from 1997. This surge in tax revenues has facilitated unprecedented increases in public expenditure over this period, but not all of this has delivered good value-for-money for taxpayers.

## 1.2 Challenges and opportunities of globalisation

The international business environment is unrecognisable from that which provided the backdrop to the work of the last Commission on Taxation in Ireland in the early 1980s. Global corporate structures and trade and investment flows have evolved extensively in the intervening years. It is therefore imperative that the work of the current Commission fully takes on board the context of global business practices. This is of particular relevance not just to the taxation of corporations but also of labour. The move towards a

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<sup>1</sup> Amongst OECD countries in 2006 the following countries has tax burdens lower than Ireland: Switzerland, Mexico, US, Korea, Greece, and the Slovak Republic.

common EU labour market has already resulted in increasing labour mobility, a trend which Ireland has experienced more than most EU member states in recent years. A global labour market has also emerged for those with high skills, whereby traditional labour market access restrictions often no longer apply. This revolution in the mobility of capital and labour has substantive implications for the way in which Governments must formulate taxation policy. The need for flexibility and agility in taxation systems has therefore never been greater.

Globalisation provides a range of challenges and opportunities for policy makers. Small open economies such as Ireland have benefited greatly through attracting mobile investment and availing of increased market access to sell goods and services internationally. Capital has never been more mobile and increasingly tax systems are an important factor in firm location decisions. To date Ireland has largely been a beneficiary of this and has been very successful in attracting high quality foreign direct investment (FDI). Our success to date, however, also highlights the relative insecurity of much of this investment and Ireland could just as easily in the future suffer as a result of tax competition from other investment locations. Increasingly Ireland must focus on its competitive standing not just in the EU but globally.

Ireland's decision to introduce a corporation tax rate of 12.5% has clearly paid rich dividends. It has demonstrated the merit of having comparatively lower taxes on the most mobile factors of production. Low corporation tax attracted mobile investment and resulted in substantial tax revenue increases not only from corporation tax but also for income and consumption taxes. It has been one of the most important examples in a European context of how the tax system can be developed to enhance economic growth. The increasing number of global corporate headquarter emigrations has shown that business is more responsive than ever to the actions of tax authorities. While it might prove ideologically challenging for some sections of society, the Commission must recognise the futility of attempts to increase the tax burden on any mobile factors of production. Furthermore it must ensure that Ireland's corporate tax offering remains on a par with the most competitive in the world.

Ireland's more recent very high economic growth rates were heavily underpinned by the influx of a much needed and highly skilled immigrant workforce from the New Member States. On a per capita basis, Ireland received far more immigrants than any of the other Member States which opened up their labour markets. While excellent employment opportunities obviously provided a strong incentive for immigrants to come and work in Ireland, relatively low income taxation has also been a key incentive. Other high waged destinations such as Denmark have struggled to attract skilled labour due to its high income and social security taxes. Immigrant workers are particularly sensitive to labour taxes and see little merit in paying high taxes now on the premise of potential social benefits at some stage in the future. Most immigrants move with the objective of maximising current earnings and subsequently returning to their homelands. Countries with relatively high labour taxes will continue to experience difficulties in attracting an increasingly mobile workforce. Given Ireland's requirement for substantial immigration in the coming decades it is essential that the Commission supports an income tax regime that is attractive to EU immigrants and provides sufficient incentive for international high skilled workers to come and work in Ireland. The threat of losing our indigenous high skills base to lower tax jurisdictions is an issue which the Commission must also take on board.

### **1.3 Tax system priorities for Irish business**

Irish business recognises the role that work friendly taxation policies have had in developing a prosperous economy. The Irish tax administration has got many things right over the past decade or so and many other countries are looking to emulate the Irish experience. For this reason it is important that Irish taxation policy remains in the vanguard of competitive tax regimes. The current tax system remains far from perfect and significant changes are required over the coming years if strong economic growth is to be maintained.

From the perspective of the tax administration it is important that a culture is maintained and further developed that is conducive to efficient business practices and decision making. The Revenue Commissioners have been recognised as one of the more progressive public bodies in terms of their modernisation agenda and it is vital that this change programme continues in the context of a rapidly evolving global business environment. The tax administration must ensure predictability, consistency and certainty for business. It must continue to be open to engaging with business in a collaborative and transparent manner in the formulation of new rules. In some case rules are introduced without sufficient consultation with business which ultimately has significant unintended consequences on aspects of economic activity. Consistency across all aspects of taxation administration is important for business. In particular, the Commission should review the administrative system for excise tax and ensure that all products are treated the same in terms of payment periods and other aspects of excise administration.

In relation to the current tax mix in Ireland it is important that some changes are made while guarantees of certainty are required in relation to other aspects. It is critical that domestic and international business is given a firm commitment that Ireland will protect and enhance its low corporation tax regime into the future. FDI decisions in particular are based on a long-term time horizon and certainty is often the most important variable. This remains a key advantage which Ireland has over many other low tax destinations in less developed countries, which may often lack political stability.

We believe that tax reliefs and expenditures should be reviewed on an ongoing basis. A range of property based tax reliefs were left in place for far too long and these schemes contributed to an ultimately damaging overheating in the Irish property market. Many of these schemes contained substantial deadweight and proved poor value-for-money for the Exchequer. Many other schemes of course have resulted in significant and desirable investment behaviour changes which have made an important contribution to economic growth. Tax reliefs remain an integral part of an efficient and effective tax system but a more rigorous approach to the selection and design of these schemes must be introduced. More quantitative techniques such as cost-benefit analysis are required ex-ante in order to ensure that value-for-money is delivered. Analyses should involve detailed examination of similar schemes available in other countries competing for the same type of investment e.g. mobile film production, and the detailed socio-economic implications of tax schemes e.g. achieving the right housing mix in local areas. Given the increased mobility of capital and the greater number of global investment options now available to even ordinary households, tax reliefs offer the potential to ensure that Ireland can use the wealth created in the past decade to stimulate productive economic activity domestically for years to come.

An important principle of taxation which Irish business wishes to see the Commission examine is that of hypothecation. Policy makers remain divided on its merits but there are numerous examples of excellent results and improved socio-economic outcomes. In

the case of any new taxes in particular, it is important that business and other taxpayers can clearly see where this additional tax revenue is spent. IBEC strongly supports the hypothecation of fuel and energy taxes towards support for energy efficiency measures. In recent years the Exchequer has enjoyed windfall gains as a result of higher global energy prices. This windfall revenue should be exclusively earmarked to support investments which will ultimately reduce energy consumption and CO<sub>2</sub> emissions.

The Irish taxation system has failed to address many important issues in recent years. The issue of household charges and local authority financing is one which the system has largely ignored for many years, while business has been forced to carry an unfair burden of local authority costs. This issue will be returned to in detail in a subsequent section of this paper. The tax system has also struggled to provide meaningful support for business led R&D activity, while the tax system has failed to provide a simple and attractive suite of incentives for those on low incomes to provide for a pension. IBEC therefore welcomes the Terms of Reference of the Commission on Taxation and sees its work as an important opportunity to improve the overall effectiveness, efficiency and economic impact of the Irish taxation system.

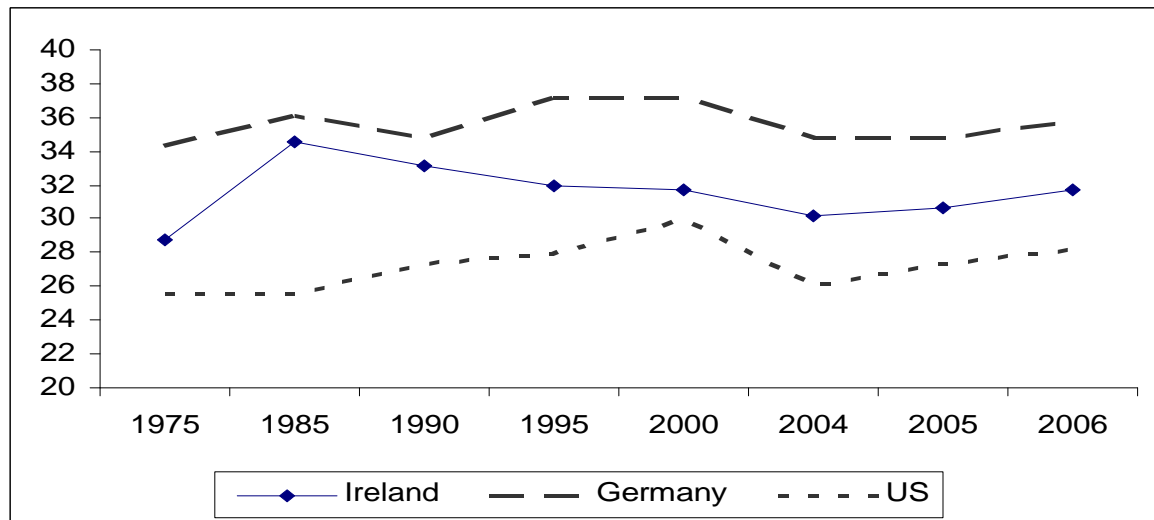
## 2. Optimum tax structure and mix

### 2.1 Balancing revenue and expenditure priorities

IBEC strongly believes that a relatively low tax burden has been fundamental to Ireland's economic recovery. Reductions in income tax have provided a strong incentive to work and have helped to almost double the workforce during the past two decades. Our low corporation and investment taxes have been central to attracting FDI and developing a strong entrepreneurship culture. Any moves to increase the tax burden on mobile investment, capital or labour would be very damaging to economic activity and would ultimately undermine total tax revenues.

IBEC does not believe that Ireland's tax burden is exceptionally low (Figures 2.1). Even countries with exceptionally high tax burdens still have to make difficult choices in relation to the allocation of scarce resources.

**Figure 2.1 Total tax revenue as percentage of GDP.**



The recent OECD review of the Irish public service highlights the challenges which the Exchequer will face in the coming decades. Overall though the review does not suggest that Ireland needs to increase its tax burden in order to fund future expenditure requirements.

Commitment to an ambitious capital investment programme; pension and health care costs associated with population ageing; and slower economic growth all look set to put pressure on the fiscal outlook. The quality of Ireland's public services remains sub-optimal in a number of areas, particularly in health and education. In relation to the quality of outcomes from the Irish health sector, the OECD review contains some interesting findings. It notes that Irish people are amongst the lowest users of health care services in the OECD but despite this the number of nurses employed in Ireland's hospitals is about double the OECD average. It is clear that increased investment in the health sector has not resulted in a proportionate improvement in outcomes. Extensive changes to the structure of the Irish health sector are required in order to improve the quality of service available to patients. These changes are likely to require some increase

in capital investment but there is no evidence to demonstrate that the health sector difficulties can be solved through increased current expenditure.

The implications of the eventual decline in Ireland's demographic dividend are likely to be significant. In the coming decades the dependency ratio will rise significantly and the cost of public sector and state pensions will increase. In order to avoid a major shock to the public finances in the coming years, appropriate action must be taken now to contain these liabilities. The affordability of public sector pensions must be reviewed and more ambitious adjustments are required to incentivise improved occupational and personal pensions coverage.

Efforts to address short-term Exchequer deficits or longer-term fiscal challenges through increasing the tax burden will prove counter-productive. Improved value-for-money in public expenditure must be the first priority, coupled with actions required to limit future liabilities to the Exchequer. In terms of social and economic policy Ireland remains on a course somewhere between Boston and Berlin – our policy makers do not have to choose either destination. They must ensure that we draw on the most successful aspects from all models and develop an efficient public sector funded by a taxation system that maximises economic growth.

## **2.2 Optimising economic growth**

A key challenge for the Commission is to ensure that any changes recommended to the tax system have a positive impact on economic growth. The tax system should also be supportive of Government policy and tax changes must reinforce rather than diminish policy objectives such as the promotion of R&D, the transition to higher value-added activity, attracting highly skilled mobile labour and encouraging greater female participation. There is an extensive body of research which assesses the impact of changes to various taxes on economic growth. Ongoing research from the OECD is particularly timely and relevant in considering this issue<sup>2</sup>. The study has addressed the following questions:

1. Does the tax structure matter for GDP per capita and its rate of growth?
2. To what extent do different tax provisions affect investment and productivity?

The study's empirical results enabled a ranking of taxes in terms of their negative impact on GDP per capita. Ranked in the order of the smallest to the largest impact on GDP from changes to the tax rates the results were:

1. Property taxes – changes to these have limited impact on GDP
2. Consumption taxes – changes have some impact on GDP
3. Personal income taxes – changes have a significant impact on GDP
4. Corporate income taxes – GDP is most sensitive to changes to this tax head

The study's findings highlight the increasingly mobile nature of corporate investment and labour. Increases to tax rates on either of these factors of production were found to have significant negative impacts on economic growth. Increases to social security costs, for either employers or employees, were found to have a similarly negative impact to increases in income taxes. Increasing property taxes, and in particular immovable property taxes, was found to be the best approach to increasing tax revenue while minimising negative impacts on economic growth. The incidence of property taxes was generally found to be low in the EU and the OECD recommend that Governments should address this issue. The OECD study also concluded that tax progressivity reduces GDP

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<sup>2</sup> Heady, Christopher. *Which fundamental tax reforms in Europe in a tax competitive environment*. OECD Centre for tax Policy and Administration. Brussels Tax Forum April 2008.

per capita. Flatter taxes can enhance GDP but obviously raise questions in relation to equity.

Globalisation and increased tax competition will place downward pressure on corporate tax revenues for many countries. Many Governments will be forced to reduce their reliance on corporate tax and shift the tax burden to less mobile factors.

The OECD has on a number of occasions said that Ireland needs to review its approach to property taxes and particular the tax treatment of housing. It has concluded that the current system which only taxes housing transactions through stamp duty is neither an efficient or equitable tax. It strongly recommends that Ireland looks at developments in relation to property taxes across the EU as it currently appears out of line with international best practice in the area.

### 2.3 Ensuring an equitable tax system

The current Irish tax system has evolved into one that strikes an appropriate balance between promoting economic growth and ensuring that all income earners are treated equitably. Significant changes to the income tax system in particular have been introduced in recent years in an effort to make the system more equitable. The introduction of the income tax credit system has facilitated greater targeting of resources to those most in need. Recent budgets have shown a very significant policy preference for helping those on low and middle incomes and families with young children. Ireland is now one of the few countries in the EU where those on the minimum wage remain outside the tax net. Irish workers on average earnings also enjoy the lowest effective income tax rate in the OECD.

Workers in Ireland on above average earnings do not fare near as well on a relative basis as those on average or below average earnings (Table 2.1). While the income tax rate for a worker on 167% of average earnings is about the same as the OECD average, the tax wedge for lower income earners is substantially lower than the OECD average. Between 2000 and 2006 the tax wedge for workers on average earnings was reduced by over one third while that for workers on 167% of average earnings only declined by less than one fifth. Therefore while Ireland is generally regarded as having very low income tax rates, it is mainly workers on average and below average earnings that benefit from this, while higher income workers experience about the same tax wedge as similar workers across the OECD. This has led to difficulties in attracting high skilled mobile labour to work in Ireland. If policy makers are serious about developing a world class knowledge economy then it must ensure that Ireland remains an attractive place for mobile high skilled labour. The ongoing rise in Ireland's cost base and the continued high level of housing costs in particular are off-putting for foreign workers, while the removal of the remittance basis of taxation has damaged Ireland's attractiveness as a temporary career base.

**Table 2.1 Income tax as a % of gross wage earnings, single person without children.**

Earnings level	67% of average	100% of average	167% of average
Ireland	4.6%	9.7%	21.9%
OECD Average	11.2%	15.7%	22.3%
Difference	-6.6%	-6.0%	-0.4%

Source: OECD. *Taxing Wages 2005/06*.

The relatively high tax wedge experienced by higher income workers in Ireland also rebuffs the view that the tax system is more favourable to the wealthy rather than to those on lower incomes. Debate on tax equity in Ireland has to date excessively focused on the cases of a very small number of high income individuals. Prior to recent budget

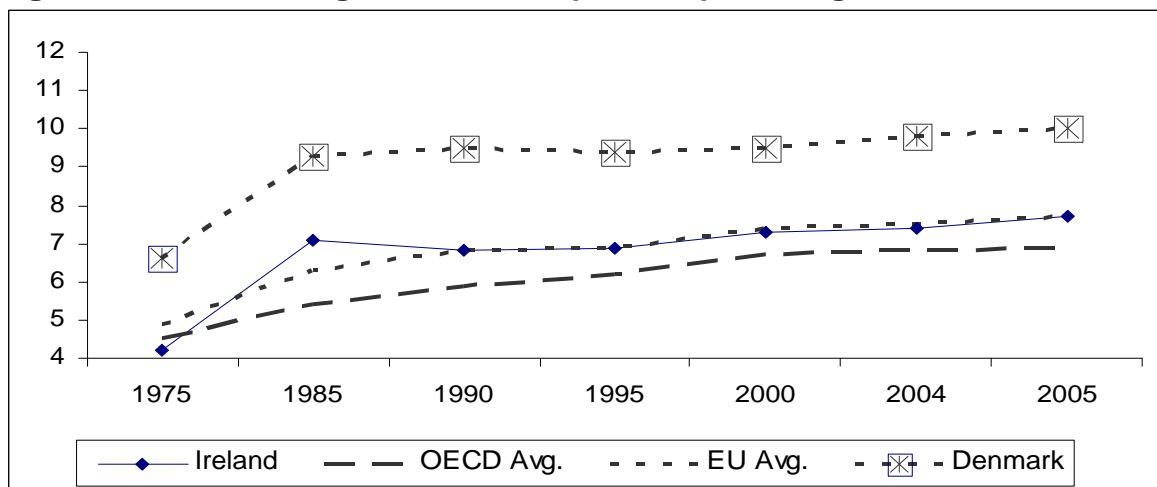
changes it was possible for high income earners to reduce their effective tax rate to zero through investing in a range of approved tax relief schemes. This issue has now been addressed through an overall cap on tax reliefs. Revenue Commissioner data also show that the top 20% of earners in Ireland contribute 80% of the total income tax revenue. At the very top of the income distribution the highest 5,400 earners in the State contribute 11% of the total income tax revenue. It must also be recognised that measures to increase the tax burden on high income/wealth individuals will merely result in them becoming non-resident.

## 2.4 Choosing the best tax mix for Ireland

Changes to Ireland’s tax system over the past decade or so have resulted in a relatively appropriate tax mix. Our high dependence on corporate tax revenue makes Ireland somewhat vulnerable to more aggressive tax competition from elsewhere or indeed efforts at an EU level to harmonise corporate tax systems. The Commission must ensure that it sets out a taxation framework which is capable of responding swiftly to changes in the global corporate tax environment if Ireland’s current relative advantage in this area is under threat. Declining international corporate tax rates in recent years have had little or no impact on Ireland’s corporate tax revenues and at present there is nothing to suggest that this threat will intensify in the short-term. From a medium-term perspective, however, there is clearly a danger that Ireland’s corporate tax base could be eroded. In relation to an issue of consistency in the corporation tax area the Commission should review the corporate tax rate on mining. The current rate of 25% is high in international terms and is a significant disadvantage to investment in new development projects.

Current economic research and developments in other countries suggest that Ireland’s consumption taxes are at an appropriate level – and overall are almost identical to the reliance on consumption taxes across the EU. In any case the EU VAT framework provides Ireland with limited opportunities for changes to VAT rates. In relation to excise duty, IBEC does not see any merit in seeking to increase rates in an effort to either increase tax revenue or achieve certain social policy objectives. Excise rates on alcohol in Ireland are already exceptionally high and further increases would be likely to result in growing cross border trade and a decline in total tax revenue. The available research also indicates that higher excise duty will not be effective in targeting the consumption behaviour of those who misuse alcohol. Indeed it may be worth reviewing how effective the current system is in achieving this objective.

**Figure 2.2 Taxes on general consumption as percentage of GDP**



As outlined in Section 2.3, Ireland offers low labour taxes for those on low and average earnings but those on above average earnings face a similar tax wedge to the OECD average. As a result of cost of living and other factors, Irish businesses are already finding it difficult to attract high skilled mobile labour. The growing importance of the internationally traded services sector to Ireland's economic prosperity will make the ability to attract high skilled labour even more significant in the coming years. While the gap in the mobility of highly skilled and unskilled or semi-skilled labour has narrowed in recent years (at least in an EU context), it still holds true that higher skilled labour is likely to be more mobile. The work of the Commission must recognise this factor and should propose measures which will ensure that Ireland becomes a more attractive location for high skilled workers. On balance, Irish business feels that taxes on labour are reasonably appropriate but some innovative efforts are required in order to help companies attract high skilled labour while it is imperative that no changes are made which adds further to the tax wedge for higher income earners. In this regard IBEC remains opposed to Government proposals to lift the ceiling on employees PRSI.

Taxes on property remains the area where Ireland is most out of line with tax policy across the developed world. The Commission should review in detail the current system of property taxes with a view to increasing the efficiency of property utilisation. If the Commission deems that total tax revenues are insufficient to fund future public expenditure requirements, property taxes present the least economically damaging opportunity to increase the tax burden.

## 3. Tax and savings

### 3.1 Pensions and savings context

Rapidly rising life expectancy, higher living standard expectations and significant increases in the real costs of elder care are combining to substantially increase the level of savings required upon retirement. Traditionally the state pension and occupational pensions were the main source of income upon retirement. Increasingly, however, individuals are choosing to diversify their asset portfolios with large numbers investing in property and equities as forms of long-term savings. Savings of this nature are primarily confined to middle and high-income households, however, and a major long-term savings shortfall is emerging amongst those on low incomes. In relative terms, the state pensions pillar in Ireland is one of the weakest in the OECD. The occupational pensions model in Ireland has worked well to date and the tax relief element of this has been instrumental in ensuring good occupational pensions coverage for middle income earners. Further measures are now required to tackle the inadequate savings level of low and some middle-income earners.

### 3.2 Savings deficit

Occupational pensions coverage in Ireland is sub-optimal and the state pension will be insufficient to support the financial needs of most retirees. A significant number of individuals have made personal investment choices in areas other than pensions in order to fund their retirement, while the higher incidence of female participation in the labour force also means that many households of the future will benefit from double incomes on retirement. Despite this, it is clear that a savings deficit exists in Ireland.

The most recent CSO Quarterly National Household Survey (QNHS) module on pensions coverage found that at end 2005 total coverage (personal and occupational) in the state was 55%, a 4% increase from end 2002. Coverage was found to vary greatly by socio-economic characteristic and is higher amongst males than females. Pensions coverage of 65% was found for the 35-54 age group, while it was also greater amongst higher occupational groups. It appears that the relatively low average age of Ireland's workforce combined with the recent surge in the number at work has resulted in lower pensions coverage. It is therefore reasonable to expect that under the current policy status quo, pensions coverage will increase further in the coming years as employment growth slows and the workforce ages somewhat.

An analysis of the expected main source of income on retirement for those currently without a pension provides some useful focus on the overall savings deficit. It shows that almost 40% of those currently without a pension will rely on the state pension while almost 30% don't yet know how they will fund their retirement. The remaining 30% will rely on other savings and investment, a spouse's pension or plan to start a pension themselves. Therefore when the current rate of pensions coverage and other savings plans for retirement are taken into account, about 600,000 or 30% of the labour force appear to be ill-prepared for retirement.

We know from a number of recent reports on the wealth of Irish households that at a macro level Ireland compares very favourably internationally. Even when the wealth built up in property is excluded the stock of wealth held in Ireland at €65,000 per capita was the 5<sup>th</sup> highest in the EU. We do not have sufficiently detailed information on the

distribution of this wealth but it is reasonable to assume that it is concentrated in middle and high-income households.

The CSO QNHS module on SSIA accounts also provides some useful information on the savings issue. At end 2005 it found that almost 50% of SSIA account holders planned to reinvest their funds in either pensions or other savings or investments. Almost half of those at work had taken out a SSIA account and significantly 27% of account holders (230,000) did not have a pension. The SSIA model has clearly been very successful. The Commission must take cognisance of the success of this scheme and seek to replicate aspects of it in other long-term savings schemes. The main principles to be built on should include simplicity and ease of understanding; same benefit to all income earners; flexibility in contribution level; preference for flexibility in savings timeframe.

### **3.3 Role of tax system in promoting savings**

The Irish tax system must address two key issues in relation to savings. Firstly, the support for occupational and personal pension schemes must be maintained. IBEC is strongly of the view that any dilution of the taxation benefits of pensions will result in a significant decline in pensions coverage. Secondly, more innovative tax supported savings schemes are required for low and middle income earners, in particular.

In relation to the tax relief available on pension contributions the current system provides a much weaker incentive to those who are on the standard rate of tax and no incentive at all to the 35% income earners who are currently tax exempt. The Commission should examine the option of providing equal incentive to all income earners to provide for a pension.

Specifically our proposals are:

- For the top rate taxpayers, tax relief at 41% would continue to be available on pension contributions
- For those in employment taxed at the standard rate or those who are tax exempt Government should top up the tax relief available so that all income earners would effectively receive support on a €1 for €1 basis when contribution to a pension. This would effectively create a level playing field in terms of Government support for pensions for all income earners
- Qualifying pension contributions could be invested in existing pension products, PRSAs or other long-term savings instruments

Even assuming a relatively high take-up of this scheme the total annual cost to the Exchequer would not exceed that of the SSIA scheme.

Other innovative taxation solutions must also be examined in order to address the savings deficit. Specifically the issue of phased retirement, and related tax and benefit issues, and more flexible long-term savings products should be reviewed. Optional delayed retirement could provide a range of financial and work-life balance benefits for employees and could also help employers more effectively manage the departure of staff from the workplace on a phased basis. Where employees choose to work beyond the standard retirement age, on either a full-time or part-time basis, the tax and benefits system needs to embrace and reward this option. The Commission should examine the following issues:

- The introduction of improved tax credits for those still in work beyond the standard retirement age. Some minor changes have been made in recent Budgets in this general area but more substantive improvements to tax credits are required for those who remain in paid work on either a full-time or part-time basis

- Employees remaining in work after the standard retirement age should be allowed to postpone their state pension entitlements until they choose to retire fully and the savings accrued should be paid to them (or their spouses) in the form of increased pension payments for the first ten years of retirement.

In relation to the issue of more flexible savings products the Commission should consider providing tax relief for saving schemes which could be partly drawn down before retirement. Full tax relief should be available on all amounts paid into certain approved schemes and a sliding scale of tax relief clawback should be applied if monies are withdrawn prior to the standard retirement age. Account holders should be provided with full flexibility as to when withdrawal might occur but there should be a cap on the total number of withdrawals over the life of any given savings account.

## 4. Costs and benefits of tax expenditures

### 4.1 Overview of current reliefs

Table 4.1 provides a summary of the cost of allowances and reliefs for 2004, the latest year for which data are currently available. The table contains details on a mixture of personal income tax reliefs and credits which are an integral part of the income tax system and estimates for tax foregone for schemes such as the Business Expansion Scheme or film relief. The total 'cost' of all tax reliefs, including the personal income tax credits, is estimated at €13 bn for 2004. Many of these are necessary on equity grounds, or imputed costs associated with work, while others are justified on a cost benefit basis and result in significant behavioural impacts e.g. in the absence of tax relief at the current level little or no contributions would be made to pension investments.

Budget 2006 curtailed many of the property based tax reliefs which have been wound up on a phased basis. Some of these had clearly outlived their usefulness and ultimately may even result in some negative socio-economic consequences for certain parts of the country e.g. the Rural Renewal Scheme. Many of these tax reliefs contained significant deadweight and rated poorly on a cost benefit basis. Therefore while many of the investments supported through tax reliefs were worthy of Exchequer support, Government could have chosen a much more cost effective approach through which to provide funding. In general the schemes did not receive sufficient prior appraisal through the use of proven quantitative assessment techniques and there was a lack of information available in relation to the precise cost to the Exchequer of the schemes funded.

#### 4.1 Cost of selected tax reliefs, 2004 (€ mn).

Basic personal reliefs	5,629
Child benefit (tax foregone)	405
Mortgage interest	232
Health insurance	219
Pensions (Green Paper on Pensions Estimate for 2006)	2,900
Capital allowances	1,684
SSIAs	548
Films	20
Business Expansion Scheme	21
R&D tax credit	71
Tax incentives including property based schemes, stallions etc	323

Source: Revenue Commissioners.

### 4.2 Principles of cost effective tax reliefs

Tax reliefs have clearly not always provided the best value-for-money for Exchequer resources in the past. The nature of many tax reliefs means that the cost to the Exchequer ultimately depends on the level of take-up. A number of schemes therefore remained in existence long after support could be justified on economic grounds. Many of the existing schemes and reliefs, however, continue to provide good value-for-money and the Commission should endorse continued Government support for them.

While the quantitative aspect of undertaking a detailed cost-benefit for the reliefs is an integral part of the appraisal process, it is important that other factors are also taken into account in areas of economic development. An increasingly important dimension from a competitiveness perspective is the existence of similar incentive schemes in other countries. This is particularly relevant in the context of very mobile investment activities in which tax relief has become a vital location determinant. In the case of both Film Relief and the R&D Tax credit scheme for example, the activities covered are particularly mobile and similar tax schemes operate in other countries specifically aimed at attracting this investment. Ireland is therefore operating in an increasingly competitive market for investments of this nature and unless the tax reliefs on offer here can match, and adapt in line with, what is available internationally, it will be very difficult to win new projects.

In general, there should be much greater transparency in relation to the uptake, costs and benefits associated with all tax reliefs. At present there is a very significant time lag in the publication of the costs associated with tax reliefs. Greater onus should be placed on the beneficiaries of reliefs to provide more complete and timely disclosure of relevant information. A target should be set for the publication of cost estimates in each Budget for the previous calendar year.

#### **4.3 Comments on specific tax reliefs and expenditures**

A number of issues in relation to the application of certain tax reliefs and schemes are of particular interest to IBEC members and are addressed in further detail here.

- **R&D tax credit scheme:** the introduction of this scheme has been an important boost to industry-led R&D activity in Ireland. In particular, it can often be the decisive factor in helping Irish multinational companies win projects which are competed for globally across a group. Many other countries competing for mobile R&D investment also have attractive tax credit schemes, a number of which are more beneficial than the Irish scheme. Given the importance placed on R&D by current Government policy and the targets agreed with the EU, it is essential that some improvements are made to the scheme in order to ensure that Ireland becomes the location of choice for R&D activity.

The most significant drawback to the current scheme is that it operates on an incremental basis only, by providing firms a tax credit on eligible investment in excess of what was recorded in a given base year. Those firms with particularly high R&D investment in the base year therefore receive little or no benefit from the scheme. In order for the scheme to be fully effective to all businesses it must move towards a complete volume based scheme.

The R&D tax credit scheme also remains restrictive due to the ineligibility of certain expenditure items. The current treatment of clinical trials within the scheme provides a particular difficulty for many pharmaceutical companies based in Ireland. In order to access specialist skills and technology many companies have no choice but to outsource aspects of clinical trials and this expenditure should be fully allowable within the scheme.

While the R&D tax credit scheme is proving very useful for many businesses, there is still a large cohort of companies which is not in a position to avail of the credits. Companies not currently making profits see little or no merit in the scheme as it is currently designed. In order to support young innovative companies, in particular, firms not currently making profits should be provided the option of taking a cash

equivalent in the year following the R&D investment in order to give much needed support to company cash flow.

There are also cases within the context of a global group of companies for which the availability of a bottom line tax credit does nothing to help competitive R&D project bids which are assessed on a before tax basis. In such cases the R&D tax credit scheme is unable to fulfil its original objective and important R&D projects are ultimately being lost to Ireland. IBEC recommends that an alternative incentive scheme should be considered for these multinational companies in order to help them improve the attractiveness of their project bids. The Commission should examine the option of using an employers PRSI offset as an alternative to the R&D tax credit in such cases.

**Film relief:** The Film Relief scheme highlights the importance of providing a tax relief scheme in a mobile investment sector which keeps pace with the offers available in other jurisdictions. The Irish scheme is no longer as attractive on a relative basis as it was some years ago and the industry here is now struggling to remain competitive. Similar tax schemes in other investment locations eager to develop their film industries have improved and Ireland has fallen down the ranking order. The Commission should put in place a continuous review scheme that ensures reliefs offered in Ireland at least match those of main competitor jurisdictions.

**Impact of cap on tax reliefs on philanthropic donations:** a cap on the total amount of all tax reliefs from which an individual tax payer can benefit was introduced in Budget 2006. Any tax payer with an income in excess of €250,000 can only benefit from tax reliefs up to a cumulative maximum value of 50% of their gross income in any one year. The reliefs covered by this cap include, inter alia, property based schemes, pension contributions and charitable or philanthropic donations. Unlike all of the other tax relief schemes included in the cap, tax payers receive no investment returns or other financial benefit (other than the tax relief) from charitable donations. Introduction of the cap has been very damaging to philanthropic organisations and charities. These organisations had just begun to see the benefits of a wealthier Ireland in terms of growing charitable donations. IBEC contends that there are very strong social policy grounds on which to exclude charitable donations from the tax relief cap and urges the Commission to consider this issue. Failure to exclude such donations misses the opportunity of channelling significant resources to areas of need and the promotion of a more cohesive and inclusive society.

## 5. Local Government Financing

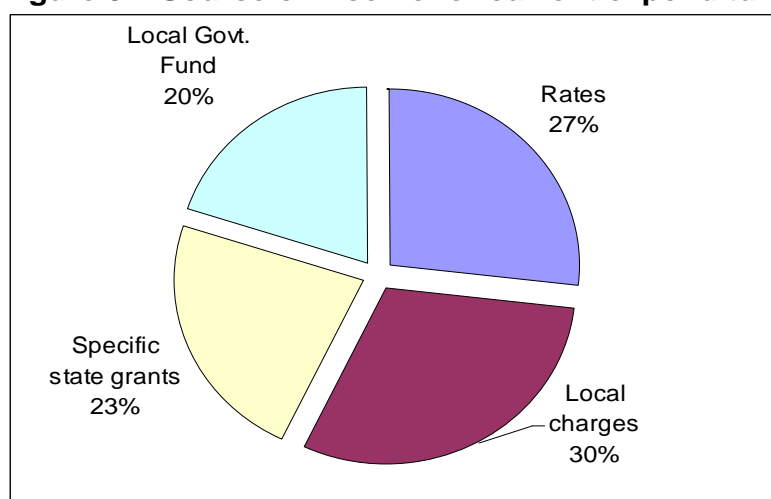
### 5.1 Overview and context

It has been evident for a number of years that Ireland's approach to local Government funding is out of sync with that in other developed countries and the model has become unsatisfactory from the point of view of local authorities themselves and the business community. Successive Governments have failed to grasp what is perceived to be a politically sensitive issue. The property boom of recent years has helped paper over some of the difficulties in funding structures through the availability of windfall gains from development levies. Given the current difficulties in the property sector, many local authorities are about to face short-term funding crises and the issue of financing local Government will become increasingly topical. The Commission must look to develop a more appropriate long-term local Government funding model which ensures that sustainability, equity and environmental considerations are fully taken into account. The Commission should also be mindful of the inconsistencies and inefficiencies in the current local Government structures. Successful reform of the financing structures requires appropriate changes to the role and responsibilities of local Government.

### 5.2 Current funding structures

Local Government in Ireland receives substantial funding from the centre, with over 40% of funding in 2006 coming from either the block grant from the Local Government Fund or through dedicated funding for specific programme areas (Figure 1). Local charges for the provision of goods and services provide for a much lower share of total revenue than is the case internationally, while rates which make up about one quarter of all current revenue are only charged to the business sector.

**Figure 5.1 Source of income for current expenditure, 2006.**



Source: DEHLG.

The demands for local authority current expenditure have increased substantially in recent years. Strong population growth, increased demand for local services and some increased responsibilities from central Government have all resulted in higher cost structures for local Government. Increases in staff pay, particularly following the first

report of the Public Sector Benchmarking Body, have also been a major cause of expenditure growth.

In order to bridge the shortfall in finances, local authorities have implemented substantial increases in commercial rates and user charges in recent years. Since the start of this decade commercial rates have increased by an average of 60%. While the rate of increase has moderated somewhat in more recent years a number of local authorities implemented commercial rate increases well ahead of inflation in 2008.

In addition, the increases in charges to businesses for water services have been more pronounced in recent years. For 2008 the average increase will be 18% - ranging from 0% in Waterford County Council to 72% in Clare County Council. Increases of this scale are clearly excessive and pose significant challenges for many businesses at a time when a range of business costs are rising rapidly.

Recent years have also seen a growing reliance by many local authorities on developer levies in order to fund much needed infrastructure at local level. In 2006, local authorities received over €671m in development levies, an increase of more than 600% over 2000. These windfall levies were particularly prevalent in counties with extensive development potential such as Fingal and other counties close to major urban centres with available development land. At the peak of the property boom developer levies constituted a substantial proportion of total revenue in some counties and these resources were used to finance activities other than the infrastructure directly linked to the developments on which the levies were paid. Those local authorities which had become over-reliant on developer levies are now faced with the prospect of a sharp and very sudden collapse in such revenues. This is likely to have very significant impacts on the ability of some local authorities to maintain service delivery levels in the coming years without resort to excessive increases in charges and rates to business.

### **5.3 Options for reform**

The recent Indecon report has identified that local authorities are facing into a period of substantial funding shortfalls in the coming years. The sharp slowdown in development activity is going to exacerbate this already difficult situation and urgent changes are now required to local Government funding structures. The following sections set out the priorities identified by IBEC.

#### **Systems and processes**

The entire management and accounting system for local Government funding and expenditure remains inadequate. Central Government provides local authorities with considerable funding but yet it is almost impossible to determine at national level how exactly this funding is being spent. Improved national oversight and reporting mechanisms are required for the entire local Government sector so that more accurate projections for revenue and expenditure by programme area can be developed.

There needs to be much greater transparency in relation to reporting on how local authority revenues are spent. Developer levy income should be earmarked for related infrastructure only and should not be used for cross-subsidisation of services across local authorities. The current local authority accounting system fails to provide this information in a clear and transparent manner. There also needs to be improved transparency in relation to how commercial rate income is allocated across expenditure areas.

The whole area of local Government taxation also lacks certainty and this is a source of major frustration for both business and the local authorities themselves. As with other aspects of the public sector budgeting process, annual grants/budgets are not decided

until very late in the previous calendar year or at the start of the current year. This means that local authorities often don't inform businesses until well into any given calendar year in relation to changes to their water charges or commercial rates.

### **Broadening of tax base**

The current slowdown in the property sector means that the issue of base broadening for local Government revenue can no longer be avoided. The Commission should recommend to Government in the strongest possible terms that urgent broadening of the local Government tax and charges base is required. It is entirely inequitable and unsustainable that business is left to carry the burden for higher charges in recent years, while it is contrary to EU and international policy that 'polluter pays' principles are fully adhered to in relation to the provision of local services. As a first step user water charges must be extended to all users, while rates should also be extended to include all non-household premises, irrespective of ownership i.e. public sector buildings should be subject to rates.

The Commission should also review the issue of taxes on immovable property. Stamp duty on both residential and non-residential properties remains an ineffective and inefficient tax. It has resulted in sub-optimal utilisation of the housing stock in particular. There are numerous flaws with its current design and it is likely that from time to time in the future, debate around rates and thresholds will continue to destabilise the housing market. The Commission should examine a potential phasing in of annual tax charges on immovable property, taking into account the principle that this is the least economically damaging approach to increasing tax revenues. It is difficult to see how allocating a proportion of other tax revenues such as income or VAT to local authorities could be administered efficiently.

## 6. Tax and environmental objectives

### 6.1 Overview

The rationale for using environmental policy instruments is based on the existence of negative externalities. Policy instruments aim to internalise these costs, so that the producer and consumer are faced with the true cost of their actions. A wide range of policy instruments exists, ranging from information provision and voluntary agreements to command and control instruments and regulation.

Environmental taxes fall in the group of economic instruments, which also include measures such as tradable permits, direct subsidies for environmental improvements and enforcement incentives for non-compliance with environmental objectives. Taxes and levies are most likely to be successful when the objective is to change the behaviour of a wide range of production and consumption activities, or where the tax or levy sends a very clear signal and the polluter is easily able to shift behaviour to a less polluting activity. The plastic bag levy, very successful in Ireland, is an example of the latter type.

### 6.2 Principles of environmental taxation

The first and foremost principle in the design and implementation of environmental policy instruments is that the environmental objective must be clear. The goal must be to change and correct environmentally harmful behaviour of economic agents, not to raise revenue for the Government. Pragmatic best practice is to use a suite of different levers, depending on the specific issue at hand, rather than choosing policy tools based on ideological convictions.

Environmental taxes should be simple, and not increase the administrative burden of the tax system, or compliance costs for business. They should be implemented equitably. Since Ireland is a trading nation, and a small open economy, it is crucial that the impact on competitiveness be taken into account in the design of any environmental tax.

Environmental taxes should also be revenue neutral, not increasing the tax burden in the economy, with transparent hypothecation. An example of lack of transparency comes from the use of energy taxes. While energy taxes are not an explicit environmental tax, they do nevertheless act in a similar way. The Government's revenue from energy taxation has increased by 75% in the period 2001-2007, and recent large increases in fuel prices have provided Government with a significant revenue windfall. IBEC believes that the increased revenue should largely be recycled by way of increased supports for energy efficient equipment in industry; public transport; fuel-efficient vehicles; and those capable of running on alternative fuels.

IBEC supports user-based charges as a useful environmental policy lever, where these are implemented equitably across all sectors of the economy. The current system of water charges lacks equity, consistency and transparency. At present only commercial users pay, charges vary widely across the country and while business should only pay the marginal cost for capital infrastructure, the lack of transparency makes verification extremely difficult. The lack of domestic charges results in Ireland using almost 20% more water per head than the UK where domestic water charges exist. This has resulted in more supply and treatment infrastructure being built than required.

### **6.3 Harnessing the value of industry action**

Fiscal instruments do not always take the form of taxation. Given the relatively short payback periods most firms expect from capital investment, and the longer payback periods inherent in energy efficient technologies, judicious use of tax incentives can aid business to minimise their carbon footprint. The incentives for capital investment announced in the 2008 Finance Bill are welcome, and more consideration is required as to how the tax system can incentivise the deployment of energy efficient technologies.

For many environmental problems, a fiscal instrument may not be the optimum approach. For instance, in the case of littering a tax may not send out a signal to individuals to change their behaviour. An information campaign or a voluntary industry initiative may be more successful in inducing change in behaviour, while a tax or levy might result in the revenue being used to simply finance a clean-up operation.<sup>3</sup>

Voluntary producer responsibility initiatives allow the relevant business sector flexibility to respond to the problem and to devise a least-cost solution. As an additional advantage, a review mechanism will be in place to verify whether industry has been successful in addressing the problem. Government retains the option of reverting to a legal or fiscal instrument if necessary.

To date, Irish business has undertaken a number of successful voluntary initiatives. Repak, the industry's producer responsibility initiative to meet Ireland's targets under the EU packaging directives, has met and exceeded the targets of 25% recovery in 2001, 50% recovery in 2005, and is well on the way to making the upcoming 60% target. After a successful pilot project, the Gum Litter Taskforce has launched a nationwide campaign to tackle the issue of chewing gum litter. Banks and other stakeholders have come together to reduce litter arising from ATM receipts. Results have been achieved through the introduction of a few relatively simple measures, such as providing good disposal facilities adjacent to the ATMs and providing receipts by request only. The chemical sector's Responsible Care initiative has clearly shown very significant levels of individual and collective improvement.

### **6.4 Carbon tax**

Irish business is conscious of its shared responsibility to reduce green house gas emissions and help mitigate climate change, together with private households and public authorities. IBEC believes that for Ireland to remain competitive, maintaining sustainable economic growth, we must make a transition to a low carbon, energy efficient economy. Putting a price on carbon is a way of internalising the true costs of emissions and will help drive the shift towards a low carbon economy. IBEC recognises the need for a price signal across all of society, to drive innovation and to deliver behavioural change.

The remit of the Commission on Taxation to consider how a carbon tax might be implemented. A carbon tax, however, is not the only available mechanism for imposing a price on carbon and a detailed analysis must take place on the options, be it a carbon tax, personal carbon credits or some form of 'cap and share' trading, to ascertain which would be most economically effective. Some or all of these will likely be new taxation measures and therefore must, as with all proposed climate measures, be subject to a full cost-benefit and regulatory analysis. This work should be undertaken by the Technical Advisory Steering Group who are formulating Ireland's response to the proposed 2020

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<sup>3</sup> A tax would be imposed on all consumers of the good, thus penalising those who do not litter. Moreover, a tax or levy used to finance cleaning up of litter might legitimise a 'since I pay the tax anyway, I am entitled to litter' mentality.

Commission targets. Measures should be fully costed, prioritised and implemented in a sequence based on least cost.

Significant changes have happened since the Irish Government last considered a carbon tax. The Kyoto Protocol has been ratified. The EU Emission Trading Scheme (ETS) has placed a price on carbon for one section of society. The EU Commission has proposed extremely challenging 2020 greenhouse gas emission reduction and renewable energy targets. Energy security has become an increasingly pressing issue.

Whichever method of applying a price for carbon is chosen, IBEC's concerns regarding competitiveness, neutrality, equity and proportionality must be addressed. A price for carbon can act as a signal for society to move towards a low carbon economy over the longer term. A price for carbon by itself will not be enough, however, least of all to enable Ireland to meet its very challenging 2020 targets. A wide range of other measures must be introduced, alongside imposing a price on carbon.

It is also imperative that any carbon pricing measures must be carefully evaluated in order to ensure that they are integrated with and complementary to the objectives of the current tax system.

IBEC firmly believes that any revenues raised by a carbon must be ring-fenced and returned in the form of lower labour taxes and as incentives to deploy low carbon and energy efficient equipment. Securing the transition to a low-carbon economy will require substantial investment from both the private and public sectors. Government must accelerate supports and incentives like the Enhanced Capital Allowances Scheme, the Low Carbon Technology Incubator Scheme and the Energy Efficiency Loan scheme, all run by the Carbon Trust and covering 15 categories of technology and 13,000 products. These schemes increase the uptake of low carbon technologies and improve efficiency.

IBEC believes that the long-term, global competitiveness of Irish business should be a key determinant in the implementation design for a carbon price, taking into consideration high and rising energy prices. When a pricing mechanism is implemented, in whatever form, it must be recognised that the bulk of Irish CO<sub>2</sub> emissions originating from the business sector already face a carbon price under the EU ETS. The remaining emissions from the business sector, 48% of total industry and commercial emissions, account for only 12% of Ireland's non-ETS emissions. Moreover, Irish industry has already made large-scale improvements: the energy intensity of Irish industry declined by 54% in the period 1990-2005.

## **6.5 The scale of the challenge**

The EU has committed to reducing greenhouse gas emissions by 20% compared to 1990 levels and, subject to a comprehensive international climate change agreement, increasing the reduction effort to 30% of 1990 emissions. The EU Commission put forward proposals on 23 January detailing how the targets will be achieved. The proposals feature a move to an EU-wide emission cap in the ETS scheme, with an overall cut of 21% on the 2005 emission levels by 2020. In addition, the EU's emissions from sectors not included in ETS – including transport, housing, agriculture and waste – are to be cut by 10% on the 2005 level. The targets for individual member states were determined according to relative wealth, ranging from minus 20% to plus 20% for the poorer member states. Ireland, ranking among the richer member states, faces a reduction target of 20%.

Ireland's national 20% target for the non-ETS sector is extremely challenging. Emissions from the non-ETS sector account for a much larger share of total national emissions than in other EU states. Our energy supply structure, large agricultural sector, rapidly

increasing transport sector and modern and efficient industrial base make Ireland more susceptible to loss of competitiveness and more dependent on achieving emission reductions elsewhere in the EU and globally to protect national competitiveness. We also have a lack of available cost-effective abatement options.

Taxes alone will not suffice; we will need a range of measures including incentives and assistance to encourage companies to progressively reduce their energy use. A pertinent example comes from the transport sector. Emissions from the sector, 27% of non-ETS emissions, are projected to grow by 35% in the period to 2020, even with a carbon tax at €20<sup>4</sup>. In fact, the large increases in fuel prices since 2004 (80c per litre to 120c) were equivalent to a carbon tax of over €100 per tonne but emissions from transport rose by 25% in the same period.

This clearly shows that fiscal measures alone will not be enough to curb the growth in transport emissions. At present, the option for consumers and business to change behaviour quite simply does not exist.

## 6.6 The implementation of a carbon tax

If after a rigorous analysis a carbon tax is found to be the most efficient option for pricing carbon, and if it is integrated with the existing taxation systems and is fully hypothecated then it must be founded on sound principles. In IBEC's view, the following are necessary for an optimal functioning of the tax:

- **Exclusion of the ETS sector:** Sectors covered by the ETS already pay a price for their CO<sub>2</sub> emissions and should be exempt from any carbon tax in order to prevent double taxation. The ETS is increasingly ensuring that power prices reflect carbon content. As a consequence, all companies already pay for the carbon costs of their electricity consumption, either directly through the ETS or indirectly further down the supply chain, through higher electricity prices.

Imposing a carbon tax on firms already participating in the ETS will lead to inefficient emissions abatement<sup>5</sup> as emissions in Ireland would decrease, but emissions elsewhere in Europe would increase by the same amount. Any form of double burden would be extremely detrimental to Ireland's competitiveness relative to other EU countries and inefficient with regard to the environmental outcome.

- **Neutrality:** The carbon tax should be revenue neutral, not adding to the overall tax burden in Ireland. This is a stated objective in the Programme for Government. The Tax Strategy Group calculated in 2002 that, in 2010, a carbon tax would raise revenue of €200-€625 million, depending on the rate of the tax. This is a substantial transfer of funds and the way in which the revenue is recycled back into the economy should be transparent and open to scrutiny.
- **Proportionality:** The carbon tax must be proportional to the pursued goals; it must be evaluated on the basis of efficiency and effectiveness in abating CO<sub>2</sub> emissions. The price elasticity of demand is low for most energy forms, transport fuels in particular. International research has shown that a carbon tax in excess of €100/tonne is required to achieve emission reductions in certain sectors like transport. A carbon price of that magnitude is clearly not sustainable for the Irish economy. Taxes alone

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<sup>4</sup> ESRI Medium Term Review 2008-2015, May 2008

<sup>5</sup> See for instance Richard Tol, *Irish Climate Policy for 2012: An Assessment*, 2007 and Böhringer et al, *Efficiency Losses from Overlapping Economic Instruments in European Carbon Emissions Regulation*, 2006

will not suffice; we will need a range of measures including incentives and assistance to encourage companies to progressively reduce their energy use.

- **Simplicity:** The administrative burden and resulting compliance costs should be kept to a minimum. The collection mechanism should be designed in consultation with industry in order to minimise transaction and other costs arising from a carbon tax.
- **Certainty:** While from an economic theory point of view, carbon tax equal to the ETS carbon price is optimal, this is infeasible in practice, since the ETS price is subject to fluctuations and tax rates are normally set on an annual basis. The alternative, suggested by the ESRI<sup>6</sup> and others, is to use the EU ETS futures market to fix the tax rate each year. The ETS price may be subject to significant fluctuations, while companies need a stable fiscal environment to be able to make long-term investment decisions. Potential annual changes in the level of the carbon tax will cause uncertainty for business and act as a deterrent to investment. The appropriate mechanism for determining the carbon tax rate should be studied. This is particularly relevant in the development of and investment in a low-carbon economy.
- **Competitiveness:** Appropriate weighting must be given to economic considerations. The Government must be aware of and give full and equal consideration to economic issues when weighing up environmental protection. The competitiveness of Irish industry relative to other major economic areas that are not subject to targets or equivalent effort must not be negatively affected.

In order to safeguard competitiveness, Irish business must be allowed maximum flexibility. Exemptions for companies already operating at best available technology (BAT), such as IS 393, must be allowed. A clear and continuous incentive for improvement must exist for operators. IBEC strongly supports the voluntary energy efficiency initiative being established by SEI and would like to see it available to as many companies as possible.

Negotiated agreements have already proved successful in a number of countries, including the UK, Denmark and Norway, and can be a very useful tool in helping companies reduce their CO<sub>2</sub> emissions. In the UK, companies are eligible for an 80% rebate on the Climate Change Levy. In the third target period companies had a 99% success ratio, with most sectors exceeding the target. The Negotiated Energy Agreements Pilot Project, the 2002 study from the SEI, indicated that negotiated agreements could be feasible in the Irish context.

The impact of additional emissions (2.2 million tonnes) and revenue from fuel tourism should be quantified and some efforts are needed to quantify how a carbon tax would impact on this.

## 6.7 Conclusions

IBEC sees merit in the use of environmental taxes in an appropriate way, when the tax will provide a clear signal for economic agents to change behaviour and when other alternative modes of behaviour exist. In some cases, however, industry action may be a more efficient means of dealing with environmental problems, and industry should have the opportunity to address the problem in a flexible manner.

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<sup>6</sup> ESRI Medium Term Review 2008-2015, May 2008

Given the new, extremely stringent 2020 climate change targets Ireland is likely to face, the implementation of the EU ETS and the need to move towards a low carbon economy there is a clear need for action.

Several options exist for placing a price on carbon and all these, along with all proposed climate abatement measures, must be subject to a full cost-benefit and regulatory analysis by the Technical Advisory Steering Group. Measures should be fully costed and implemented in a sequence based on least cost.

Any carbon taxation proposals must not only be carefully evaluated for economic efficiency but also assessed to ensure that they are integrated with and complementary to the objectives of the current tax system.

Revenues arising from pricing carbon must be hypothecated and returned as reduced labour taxes and as incentives to improve energy efficiency.

Once a tax has been shown to be efficient, integrated and hypothecated it must be implemented based on the principles of exclusion of the ETS sector, competitiveness, revenue neutrality, equity, simplicity, proportionality and certainty.