

Policy Submission

Review of Tax Reliefs and Exemptions for High Earners

**Submission to the
Department of Finance**

March 2005



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1. Introduction

- 1.1. Combat Poverty is a state advisory agency developing and promoting evidence-based proposals and measures to combat poverty in Ireland through policy advice; project support and innovation; research; and public education. We have a specific function to advise Government on all aspects of social and economic policy relating to poverty.
- 1.2. The Combat Poverty Agency understands the original rationale for introducing a range of tax expenditures and reliefs aimed at encouraging economic activity in certain industries and sectors of the economy. However, Combat Poverty has some concerns about these schemes, particularly from a taxation equity and income distribution perspective. The Review of Tax Reliefs and Exemptions for High Earners initiated by the Minister for Finance in December 2004, is both timely and useful. Combat Poverty welcomes the Department of Finance's Request for Submissions on the Review.
- 1.3. This submission sets out Combat Poverty's position on tax reliefs, focusing on social/economic aspects and distributional implications of such reliefs and their impacts on poverty and inequality in Ireland. Combat Poverty is not against the use of economically beneficial tax reliefs in circumstances where they encourage investment in vital sectors or economic activities. However, as the tax/welfare system is the main means to lowering income inequality, tax reliefs play a considerable part in reducing the fairness of the taxation system which results in less equitable income distribution and a less equal society. Ireland has a very unequal society with high rates of income poverty.
- 1.4. The Review of tax expenditures is timely and should take cognisance of the National Anti-Poverty Strategy's commitment to poverty proof all government expenditure and programmes¹. The document states that:

"The question of the impact of poverty will also be a key consideration when decisions are being made about spending priorities in the context of the national budgetary process and the allocation of EU Structural Funds" (Government of Ireland, 1997).

This was underscored in the 2001 review of the poverty-proofing process by the National Economic and Social Council (NESC, 2001).
- 1.5. This submission draws on national and international research on tax expenditures. A number of policy recommendations are presented, many of which are based on recent research funded by the Combat Poverty Agency on taxation and equity in Ireland.
- 1.6. In line with the brief for the Review, this Submission focuses on the following property-based relief incentives:

¹ Poverty proofing can be defined as the process by which Government departments, local authorities and State agencies assess policies and programmes at design and review stages in relation to the likely impact that they will have, or have had, on poverty and on inequalities that are likely to lead to poverty, with a view to poverty reduction.

- Urban Renewal Scheme
- Rural Renewal Scheme
- Town Renewal Scheme
- Living Over the Shop Scheme
- Capital Allowances for Hotels
- Capital Allowances for Holiday Cottages
- Capital Allowances for Private Hospitals
- Capital Allowances for Sports Injury Clinics
- Capital Allowances for Nursing Homes
- Capital Allowances for Third-Level Educational Buildings
- 'Section 23'-Type Relief for Student Accommodation
- Capital Allowances for Childcare Facilities
- Capital Allowances for Other Reliefs in 'Park and Ride' Facilities
- Capital Allowances for Investment in Multi-Storey Car Parks
- Relief for the Refurbishment of Certain Rented Residential Properties (Countrywide Refurbishment Scheme)

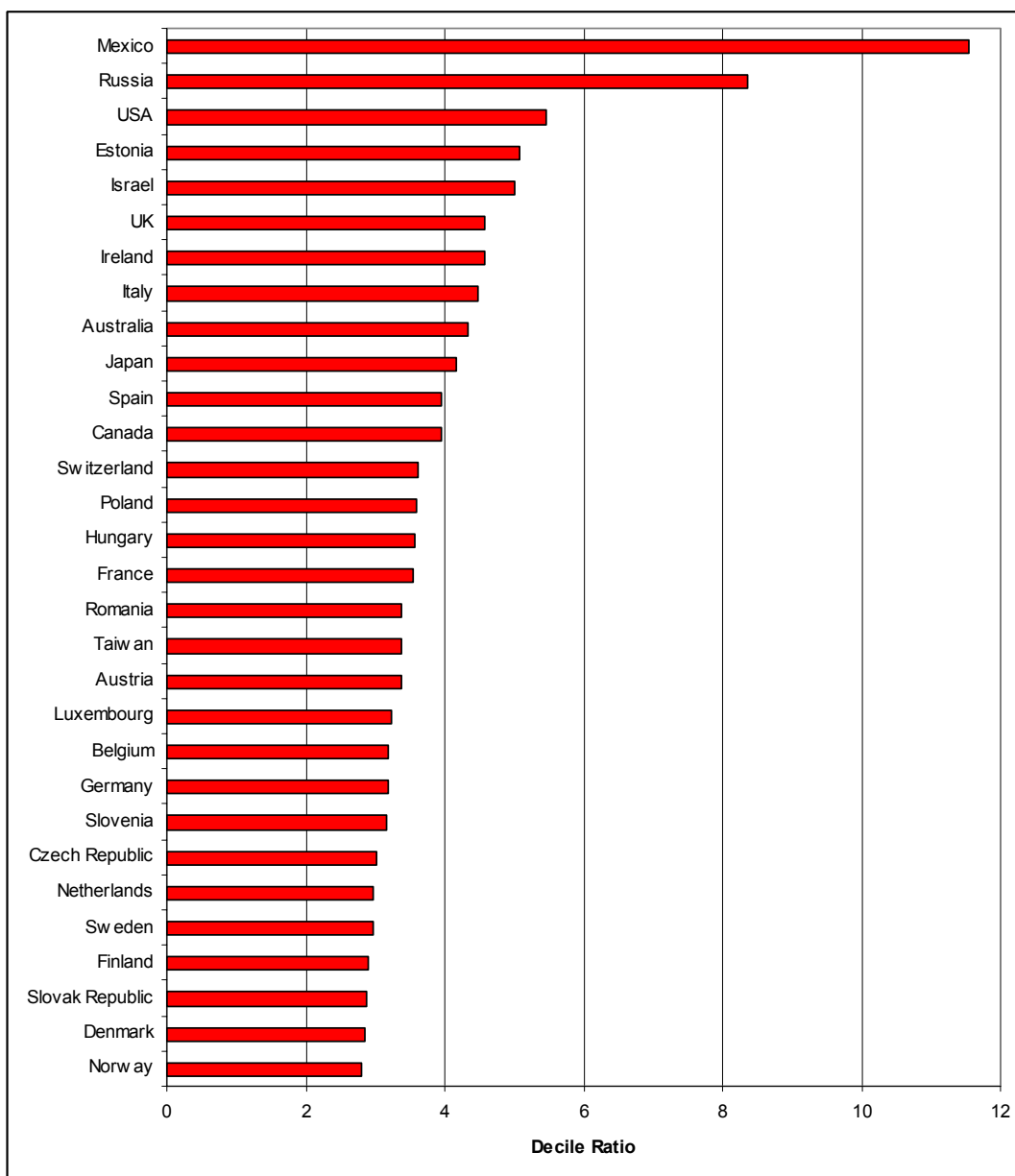
- 1.7. The Submission argues that Ireland's income distribution is particularly unequal, and tax reliefs play a significant role in Ireland's persistently high level of income inequality. As such, those tax expenditures that fail to demonstrate a net gain to society should be stopped. Those that are demonstrably beneficial to society and the economy should continue. The Submission argues that all current and future reliefs (not just the property-based ones under review) should be evaluated using formal economic evaluation techniques.
- 1.8. The Submission is structured as follows. In the next section, there is a brief overview of income distribution in Ireland. Section 3 outlines the roles of tax expenditures and relief schemes in Ireland hitherto and currently. Section 4 outlines the social and economic impacts of tax expenditures. Section 5 describes some distributional issues pertaining to the schemes. Combat Poverty's main recommendations are discussed in Section 6 and the final conclusion is presented in Section 7.

2. Income Distribution in Ireland

- 2.1. Ireland has among the most wide income distributions in OECD nations. According to recent research, only the USA, Russia and Mexico have higher levels of income inequality (Nolan and Smeeding, 2004). To place this in context, a low-income Irish person at the 10th income percentile in 2000 had an income that is just 41% of median income, whereas a high-income resident in the 90th income percentile had an income that is 189% of the median. This income gap between the rich and poor is sometimes called the Decile Ratio measure, and it equals 4.57 in Ireland (i.e. a person in the 90th percentile earns 4.57 times that of a person in the 10th percentile)². In contrast, the income of the poor in most other countries in the OECD averages 50% of the income of middle-income persons. Decile ratios for a variety of countries are illustrated in Figure 1. It is clear from this illustration that the Irish income distribution is among the most unequal in all the EU Member States, the UK demonstrating a marginally larger income gap.

Figure 1
Income Decile Ratios (90th Percentile Divided by 10th Percentile)

² The measure is useful as it does not include outliers (viz. those on very low or very high incomes).



Source: Nolan and Smeeding (2004).

- 2.2. While those well-off in Ireland are somewhat less well-off than the rich in some other OECD countries, the poor in Ireland are much less well-off than the poor in other OECD nations. This is likely to be due, in part, to the fact that increases in social welfare benefits have not kept track with wage-growth levels across the employee and self-employed sectors.
- 2.3. Turning to the anti-poverty effect of taxes and transfers, only the USA is found to have a lower anti-poverty effect than Ireland. Nolan and Smeeding (2004) demonstrated that State programmes to reduce market income-based poverty in Ireland lowered the poverty rate by just 33% compared to the average across all countries analysed of 62%³. This means that Ireland has among the least redistributive tax/welfare systems in the OECD nations studied.

³ Market income-based poverty represents poverty levels pre-taxes and social welfare transfers.

- 2.4. Over the Celtic Tiger years of the Irish economy, income inequality has remained persistent. The Gini coefficient is one of the commonly agreed indicators of social inclusion across the EU. The latest Gini coefficient from the EU Survey on Income and Living Conditions of 0.30 (2003 data) indicates that Ireland has some way to go before it achieves a more equal income distribution (CSO, 2005). Again, such inequality is likely to be due to factors such as, *inter alia*, social welfare increases not keeping pace with wage growth, very significant and dramatic economic growth resulting in a large increase in very high-paid jobs pushing the upper tail of the income distribution higher, and income tax cuts which have benefited high-income individuals more (in real terms) than those on low-incomes.
- 2.5. Overall, the international data indicate that the tax/welfare system must work harder to redistribute resources more equitably in Irish society. Tax expenditures have the opposite effect.

3. The Role of Tax Reliefs in Ireland

- 3.1. According to the Tax Strategy Group (Department of Finance, 2004a), tax reliefs have the following objectives, *inter alia*:

- Encouraging investment in certain activities or geographical areas – such as the Business Expansion Scheme, Film Relief, and Urban, Rural and Town renewal schemes;
- Reducing the cost of capital and encouraging business investment – such as interest relief and various capital allowances.

- 3.2. In his 2003 Budget Speech, the then Minister for Finance, Mr Charlie McCreevy, TD, stated:

“Reliefs narrow the tax base. A widened tax base is the price that must be paid to keep tax rates low. In my view it is a price worth paying. All tax reliefs therefore must be subject to on-going review”.

- 3.3. The following year (2004), the current Minister for Finance, Mr Brian Cowen, TD, re-emphasised this point:

“My aim is to seek to improve the equity of the tax system taking into account the social and economic benefit of reliefs in delivering investment in housing, enterprise, urban and rural renewal, tourism, films and health facilities... For the successful operation of such schemes and to achieve the common good, we need to ensure the right balance is achieved between the benefit to the investor and the good of the community....”.

- 3.4. The *Sustaining Progress Agreement* states furthermore that:

“Tax expenditures will be kept under review and will be amended or terminated if necessary in the light of changing economic and social priorities. Government is committed during the lifetime of this Agreement to ongoing review of the scope for widening the tax base, subject to the key national economic, social and environmental principles identified” (Department of the Taoiseach, 2003).

- 3.5. Total tax expenditures on income tax allowances and reliefs have been calculated to be in excess of €5.2 billion (NESC, 2003), while total tax expenditures equate to some €8.38 billion, according to the Tax Strategy Group (Department of Finance, 2004a). Bearing in mind that the total income tax take is around €10 billion and the total tax take is close to €30 billion (Department of Finance, 2004a), there is potential scope for the total tax base to be increased by up to 25% in monetary terms if tax reliefs and expenditures were abolished. It should be noted, however, that property-based tax reliefs – the focus of this review – equate to expenditure of about €2.3 billion annually. As such, the magnitude of such tax expenditures is very large.
- 3.6. While the objectives of tax reliefs outlined in 3.4. are potentially worthy, the use of the tax system in pursuing them leads to a number of economic distortions and outcomes which are often far from socially desirable. The following section of the Submission outlines the key issues to consider when assessing the feasibility and desirability of a proposed tax-incentive scheme.

4. Social and Economic Considerations

4.1. Introduction

This section outlines some important issues relating to tax reliefs. Policymakers should consider both the positive and negative impacts of such tax expenditures before deciding whether or not to continue or abolish a given tax-relief scheme. The following sub-sections outline some of the social and economic benefits of tax-incentive schemes. The subsequent section (5) presents a summary of the main distributional concerns regarding tax expenditures.

4.2. Reliefs Historically Important During Economically Depressed Times

Combat Poverty understands that tax reliefs and expenditures have an important role in the macroeconomic environment in attempting to spark investment in important sectors or certain critical economic activities that are otherwise economically unattractive. Such reliefs have been of particular importance in the past when economic growth was sluggish (or negative) and investment was difficult to stimulate. There was also some justification in their introduction, as income tax rates were highly penal, especially for high earners. Tax reliefs, when properly focused on crucial activities and sectors in the economy, can result in a social and economic gain. Certain tax incentives have been successful in spurring investment in certain activities resulting in high output, particularly in the property market. It is advisable to continue such schemes where economic evaluations have demonstrated that there have been clear benefits to wider society and the macroeconomy.

4.3. Retaining Indigenous Private Investment

In addition to these benefits, it is important to consider the loss of private investment if reliefs were abolished and the potential consequences e.g. would the money be exported out of Ireland into foreign investment? It is important for the continued future success of the Irish economy that a strong level of indigenous Irish investment is retained within the country rather than exported. Such investment creates a multiplier effect which further boosts economic growth. The withdrawal of investment funds to a foreign investment market would clearly be a very adverse result for the economy and should be avoided.

4.4. Low Level of Property Taxation

Ireland has no property tax and yet provides incentives for high earners to invest in property which has the result of driving up the market price of housing. This is at odds with taxation and housing policies in many other EU countries which often discourage speculative investment in the property market. Property investment in Ireland demonstrates the highest capital return, so there is already a very low level of risk attached thereto. The provision of property-based tax incentives merely reduces the risk even more for high earners wishing to engage in speculative investment.

4.5. Deadweight Concerns

In addition to reducing the tax base, the potential exists for a given tax relief to be simply subsidising activity that might have occurred anyway, i.e. the reliefs may be deadweight and result in large numbers of so-called 'free-riders' who would have invested regardless of the existence of these reliefs. The Second Report of the Commission on Taxation on Income Tax Incentives, published in 1986, added:

"It is not sufficient to show that the activity at which the incentive is directed is worthy and would benefit. If this criterion were accepted to justify incentives, virtually all items would qualify for incentives ... because there is almost no activity which cannot be shown to benefit from a selective reduction in taxation" (Government of Ireland, 1984).

4.6. Lack of Planning

Poor planning in advance of tax expenditure schemes can result in speculative investment which pushes up the prices of housing. The review of the Urban Renewal Scheme by KPMG highlighted this problem and called for more spatial planning to occur in future schemes, particularly area-based models. Many of the outputs of tax-relief schemes in the past have been ad hoc and supply-led with little prior assessment or quantification of what the end-results should be.

4.7. Sub-Optimal Saving Patterns

A recent OECD publication showed that tax reliefs for certain industries, locations, business forms and savings vehicles, such as home ownership and pensions, result in sub-optimal saving and investment patterns (OECD, 2001). The OECD report stresses the need for high levels of efficiency in the taxation system and urges policymakers to avoid many economically undesirable tax reliefs. It is often argued that the availability of tax reliefs can lead to economic activities that otherwise would not have occurred. This argument is a logical one to make for a variety of economic activities, especially during times of sluggish economic growth. However, the validity of such an assertion is less robust in times of economic buoyancy, like those witnessed over the past decade in Ireland.

4.8. Targeting is Difficult

While reliefs are often judged to be efficient in that there is minimal cost if they are unsuccessful (unlike grant schemes), tax reliefs have the significant drawback of being of a more general nature and may be used for a purpose much different to that originally intended or desired. This uncertainty as regards the end-use of tax expenditures may result in inefficiency. By contrast, grants or subvention programmes can be readily targeted at those for whom the benefit is intended. Monitoring is also easier in a subvention-based scheme than tax-relief schemes, and evidence suggests that grant schemes are often easier to cost and manage.

4.9. Unknown Costs and Benefits

It is alarming to note that details on the costs of a number of tax expenditures are not available; this is probably because certain tax reliefs are provided without any requirement for formal reporting. In addition, there is scant information on the numbers benefiting from a variety of the schemes. Tax-relief schemes should only come into force if there are clear net gains to society arising from the introduction of such initiatives. Some schemes in the past have cost the State substantially more than that originally planned (e.g. the Beaumont Hospital car-park). In this regard, tax expenditures must demonstrate clear net benefits to the State prior to their introduction, and *ex-post* evaluations should evaluate the success or failure of recent schemes.

4.10. Absence of Social Component

Tax expenditures have traditionally been targeted at the private sector and not the non-profit sector. It is argued that the outputs of such schemes should be less geared towards financial gain the private/investment markets, and more towards a societal benefit. Targets can be introduced, such as those introduced recently in national policymaking for social and affordable housing units. Such social benefits will improve the economic worthiness of proposed and existing tax-relief schemes.

5. Distributional Concerns of Tax Reliefs

5.1. Introduction

This section pays particular attention to distributional issues pertaining to tax expenditures.

5.2. Reduced Tax Base

The provision of tax reliefs results in a reduced tax base and hence the need for higher tax rates, as was noted by the Minister for Finance in his 2003 Budget Speech. This is at odds with Government fiscal policy which has been to reduce effective income tax rates since taking power. The reduced tax base and reduced income tax take has resulted in a paradigm shift in fiscal policy towards indirect taxation as a key means to collecting revenue. Indirect taxation is highly regressive, as those on low incomes pay proportionately more than twice than those on high incomes on indirect taxes such as VAT and excise duty (Barrett and Wall, 2005).

According to Department of Finance data, just over 19% of those returning income for tax purposes pay almost 72% of all income tax (Department of Finance, 2004b). Furthermore, the top rate of income tax (currently set at 42%) has fallen significantly since the 1980s. For the purposes of improving the progressivity of the income taxation system, any benefits gained from further widening of the tax base should accrue to those on the standard rate.

5.3. Regressivity and Inequity in the Tax System

Moreover, a major concern relating to reliefs is the reduction in progressivity that they tend to bring to the tax system. The elimination of a number of tax reliefs could go some way towards increasing progressivity and thereby act as a counterbalance to the regressive impact of the indirect part of the system, as shown in a forthcoming Combat Poverty-funded study on indirect taxation in Ireland (Barrett and Wall, 2005).

The distribution of benefits across taxpayers of the various schemes has not been examined in depth in many instances. However, a review of income tax and PRSI for low-income households carried out by O'Toole (1997) noted, "the 'topsy-turvy' distributional effects of discretionary tax expenditures, whereby higher-rate taxpayers benefit more than standard-rate taxpayers, are not justifiable on equity, efficiency or administrative grounds".

Certain tax reliefs benefit large numbers of individuals. Others are far more targeted at high earners. Of the property-based reliefs under consideration in this Review, Capital Allowances benefit 269,000 individuals, according to data from the Tax Strategy Group (Department of Finance, 2004a). This compares with 1,114,000 Special Savings Investment Accounts, 856,000 individuals entitled to work-related expenses allowable under Schedule E, and 671,000 employees' contributions to approved superannuation schemes. As such, capital allowances are benefiting a relatively small number of high earners with considerable discretionary expenditure.

5.4. Elitist Tax System

While the distributional impact of many other reliefs has not been calculated in as systematic a manner as Hughes (2000) in his assessment of pension reliefs, recent media and political discussion of the non-payment of taxes by certain high earners arising from their use of reliefs has highlighted the potential unfairness that reliefs can give rise to. The findings by Barrett and Wall (2005) in respect of the distributional impact of the indirect taxation system add an extra impetus for reform in this area. Given that lower income groups must pay a higher proportion of their incomes in the form of indirect taxes, every effort must be made to ensure that taxes on low incomes are kept as low as possible. As tax reliefs make higher rates necessary, they work against this goal and so should be avoided. This is underscored by a recent Revenue Commissioners' report (2002) which demonstrated that some 30% of the wealthiest 400 individuals in Ireland face effective tax rates of less than 30% because of their use of various tax-relief schemes, especially property tax reliefs.

6. Combat Poverty Recommendations

6.1. Tax Reliefs Should Demonstrate Clear Economic and/or Social Benefits

Tax reliefs violate many of the canons of taxation, most particularly the principle of *equity* which states that people should pay tax in proportion to their ability to pay. It is clear that tax reliefs provide high-income individuals with opportunities to reduce their effective taxable income substantially. This is completely at odds with the principles of vertical and horizontal equity and leads to reduced progressivity in the tax system. In addition, the difficulty in targeting tax reliefs effectively entails that they may be used for a purpose different to that originally intended, as has been noted in several Tax Strategy Group papers (e.g. Department of Finance, 2004a). This uncertainty regarding the end-use of tax expenditures can also contribute to economic inefficiency. Thus, the existence of tax reliefs can be held to promote an inefficient allocation of economic resources, as was stated in a recent paper by the Tax Strategy Group (Department of

Finance, 2002). It is on these grounds primarily that those tax reliefs which are economically unjustified should be abolished.

6.2. Continue 'Base-Broadening' Measures

The decision in 1998 to introduce a ceiling of €31,750 per annum on capital allowances that can be offset against non-rental income is to be welcomed. If tax reliefs are evaluated as economically justifiable (e.g. childcare facilities, nursing homes etc.), measures that broaden the tax base or those that can be termed 'anti-avoidance' should be built into the design of the expenditure scheme. Furthermore, ceilings on rental allowances should be implemented as an additional tax base-broadening measure.

Where a given scheme is considered to have some economic justification, but there are concerns that the level of 'free-riders' under the scheme is currently high, the Department should consider the option of introducing further caps or ceilings on the maximum exemptions and reliefs permissible under the stated scheme. Such ceilings will need to be chosen carefully so that there remains some incentive for the prospective investor to participate in the scheme. Other base-broadening measures should be considered.

6.3. There Should Be No Extensions of Current Property-Based Tax Reliefs

Combat Poverty welcomes the decision in the 2003 Budget to terminate the Capital Allowances for Hotels scheme and the Capital Allowances for Holiday Homes Scheme. The decision to phase out a number of other relief schemes over the coming months was also a positive move. It is regrettable, then, that the Finance Act of 2004 extended the termination dates of these schemes to 31st July 2006⁴. Any additional extensions would be contrary to Government policy on tax reliefs, as stated in Budget Speeches 2003 and 2004.

6.4. Minimum Effective Tax Rates for High-Earners Should Be Considered

Combat Poverty recommends that the value of tax reliefs for higher earners is curtailed. The latter could be achieved by standard-rating all discretionary tax reliefs or by setting a minimum effective tax rate for earners above a certain income threshold. This has been the recommendation of Combat Poverty in its last two Pre-Budget Submissions. Such a minimum tax could apply to those on high incomes (e.g. €100,000) and would ensure that everyone pays a reasonable amount of tax. In addition, such a scheme would not interfere with tax-incentive schemes provided a carefully chosen minimum income tax rate is selected (e.g. 20%). An alternative to the minimum tax rate might be to consider similar measures to those introduced by the Minister in the 1998 Budget where cumulative permissible limits were set on the reliefs an individual could avail of.

6.5. Tax Reliefs Should Be Subjected to Economic Evaluation Prior to Introduction

Combat Poverty argues that only those tax expenditures which are fully quantifiable (both in terms of numbers of beneficiaries and forgone costs) should be considered for continuation or introduction. Such schemes must be evaluated using formal economic evaluation techniques, such as Cost-Benefit Analysis, and the decision to continue with a given scheme must be based on such objective evidence-based evaluations. Transparency and continuous monitoring of the schemes are both very critical to efficient outcomes. Cost-Benefit Analysis assesses both the positive and negative economic and social impacts of reliefs before introducing such schemes. While data on identified costs may be difficult to obtain or quantify, policymakers should err on the side of caution when

⁴ IBEC has stated that under no circumstances should there be any further extensions to these schemes (IBEC, 2004).

considering the introduction of relief schemes in the absence of rigorous economic evaluations of same. An information or data deficit should not be used as justification for not conducting an *ex-ante* evaluation.

6.6. Tax Reliefs Should Result in Social Gain

The poverty impact of tax expenditures should be considered in such evaluations. This includes an assessment of a scheme's contribution towards the achievement of National Anti-Poverty Strategy targets, addressing inequalities, especially among so-called vulnerable groups, as well as helping to prevent people falling into poverty and ameliorating the effects of poverty and deprivation. A more socially desirable outcome would enhance the viability and feasibility of certain tax-incentive schemes. In the case of the Childcare Scheme, for example, it would be worthwhile investigating the economic worthiness of designating a proportion of free or affordable childcare places to those less well-off. KPMG undertook a review of the Urban Renewal Scheme in the mid-1990s and urged a re-structuring of the programme towards a model which enhanced community gain. Consideration should be given to re-structuring other schemes that demonstrate wider economic benefits but are currently lacking in strong social gain.

6.7. Reliefs Should Become Part of a Strategic Planned Approach

Ad hoc or unplanned relief schemes should be avoided as a rule. If possible, reliefs should be linked to some form of formal planning (e.g. spatial planning) where there is a demonstrated need or benefit in doing so. In the case of the Urban Renewal Scheme, for instance, Local Authorities were obliged to prepare integrated area plans in order to proceed with the scheme. This was a positive move and helped to ensure that an excess of poorly planned projects was avoided because of the urban planning exercise.

6.8. Extend Criteria to Include Non-Profit Organisations

To further mobilise investment and to improve the social gain of such schemes, it is worthwhile considering the extension of eligibility for investment in tax-relief incentive schemes to non-profit organisations without tax liabilities. There are two options in this regard: non-profit investments could be supported directly (e.g. the creation of non-profit nursing homes), or there could be an alternative parallel grants subvention scheme, similar to the Childcare Facilities Scheme. Such a move would further increase the community gain of such schemes and improve their economic desirability.

6.9. Review All Tax Expenditures

Combat Poverty also recommends that the current review of tax reliefs and exemptions be extended to include all tax expenditures, and not just the property-based incentive schemes outlined in the Background Document which are of relatively limited scope. In particular, investment in films, artists' relief and stallions' relief, pensions and the Business Expansion Scheme should all be critically examined. These schemes have the effect of reducing the tax paid by high earners. Even where tax reliefs are seen as economically or socially beneficial, their feasibility should be considered in the context of the general direct taxation system and the need to keep the tax base as wide as possible.

7. Conclusion

- 7.1. Irish society is one marked by inequality. Tax reliefs play a considerable part in reducing the fairness of the taxation system which is the main mechanism to ensure a more equal society. Ireland now has the economic capacity to achieve such a goal.

- 7.2. Combat Poverty argues that all proposed (or existing) tax reliefs must be subjected to rigorous *ex-ante* (or *ex-post*) economic evaluation. Only those tax expenditures that demonstrate a clear net gain to the economy and wider society should be continued.
- 7.3. As Nolan and Smeeding (2004) pointed out, “The increasing Irish ‘social dividend’ due to rapid growth makes such equality more affordable than in the USA”. Combat Poverty urges policymakers to ensure that this dividend is not diluted by reliefs or expenditures for high-earners, but instead results in a widened tax base which lowers income tax rates for all and makes work pay, in particular for low-income working households.

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