



Ibec policy brief

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Rethinking the tax debate - the key issues for the election

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'Winners and losers'

Income tax has become a central part of the debate in the run up to the general election. The argument over who should pay and how much is understandably one of the more contentious policy issues given how regularly and visibly it affects our lives. This debate has become even more prominent in recent years as the income tax take increased in order to fill the hole left by the collapse of the construction industry.

Unfortunately, the focus of the debate about tax and spending is often very narrow, centring on beneficiaries from incremental changes.

Commentary on tax reform is also more often than not centred on 'who got what' rather than the economic merits of policies. This often leads to a loss of perspective on how the system functions as a whole or what impact the structure of our tax system has on the economy. This is true on all sides of the ideological divide with commentary on tax issues often focusing solely on the 'winners and losers' from tax changes.

The election debate thus far has been a case in point in this regard; with parties clamouring for votes, the debate has focused on which groups will 'win' from tax changes. As a result, an escalating number of voters are being promised they'll have to pay little or no tax at all while others are promised public services funded by tax increases for 'those who can afford it' – rarely the target audience themselves. This is a continuation of the type of debate which has resulted in an income tax system which looks like that of no other developed

economy. This system is characterised by a narrow base and both very low and very high effective tax rates at each end of the income distribution.

From a business point of view a debate on tax reform is a necessary one given the economic recovery and changing global landscape. This debate needs, however, to be based on economic efficiency rather than political expediency – on this score the debate thus far has fallen short.

Do we pay enough tax to fund public services?

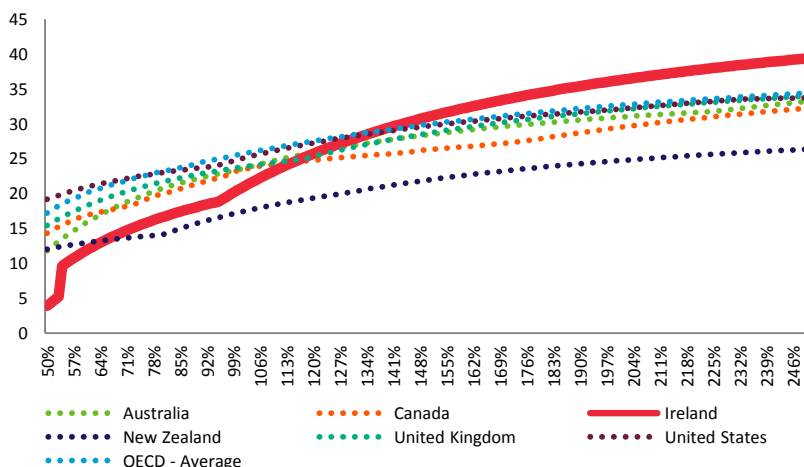
There are a number of conflicting narratives about the burden of tax in the Irish economy and whether we pay enough to fund the services we need. The answer you get depends heavily on how you compare social insurance (SI) systems.

Our view is that SI cross country comparisons are complex, prone to mis-interpretation and in either case only marginally relevant when discussing the necessary tax burden to fund day-to-day services. The reasons for this are clear; firstly, SI does not pay for the vast majority of services – schools, hospitals, investment or Gardaí etc – which are funded by the exchequer. SI is directly linked to social insurance benefits such as illness benefits, jobseekers benefit and pensions; too much commentary on Ireland's tax burden omits this fact.

This is not to ignore policy issues with SI in Ireland. The social insurance fund which administers SI collects and pays out just over €8 bn a year – with the majority (over €5.5 bn going to the state pension). The exchequer contribution to fund the deficit in the fund was €180 million in 2015 and will likely return to a surplus as the labour market continues to improve. Without policy changes, however, this is likely to reverse significantly in the coming decades as the population ages and dependency ratios grow. This will mean rising pension's expenditures funded by a proportionally smaller workforce.

The second reason for our view on SI in the comparison of tax systems is that there are large differences in the structure of social insurance systems across countries. As such including them in

Figure 1.
Figure 1: Effective income tax and PRSI rates by % of national average wage, single earner



a brief comparative tax analysis such as this is likely to trivialise the differences between them. As noted by the Mirrlees review of the UK's tax system these comparisons should be "treated with caution" as the variation in the structure across SI systems means that "the distributional and work incentive effects of social insurance can look rather different if such links (between SI and benefits) are taken into account".

In other words, the higher social contributions in higher tax countries are not redistributive – they benefit those who pay into them directly as opposed to the Irish system which levies lower rates overall but redistributes those benefits to poorer households.

In Ireland PRSI acts in much the same way as an income tax with tax collected going into a general pot with very weak links between benefits and contributions. Social insurance in other countries, particularly in Northern Europe, on the other hand is strictly linked to personal benefits such as defined contribution pensions and wage linked social welfare benefits.

In this sense social insurance in many Northern European countries is closer to private insurance even though it is often mandatory and administered by the state. These are funded through often large, direct contributions from lower and middle income earners. As a result OECD research shows that while Ireland, along with New Zealand, has the most redistributive pension system in the developed world Sweden's system is regressive. Moving toward this system would require Ireland to levy much higher SI rates on lower earners which would for the most part pay for improved out of work benefits for higher earners.

In Sweden and Germany for example people who lose their job can receive between 60% and 80% of their salary in unemployment benefit once they have sufficient contributions. Basic benefits on the other hand, for those without sufficient contributions, are only about as generous as the

Irish system (weekly unemployment benefits in Sweden for example are equivalent to about €194 when differences in price levels are accounted for). In addition, in the Northern European system, the state acts as a collector and distributor for mandatory defined contribution pension schemes for large cohorts of workers. In Germany the contribution to this DC pension is set at 18.7% of gross wages salary with half paid by the employee (9.4%). The system in Ireland is voluntary and private. These differences between Irish and European systems are not trivial and should be reflected in a thorough debate.

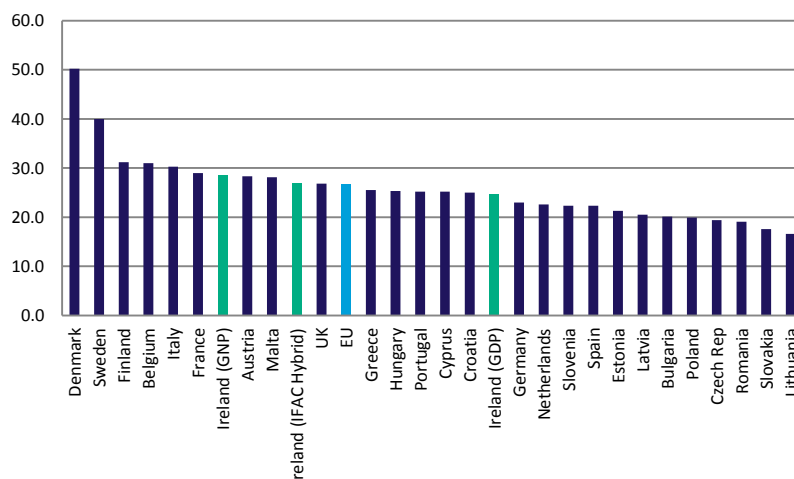
With SI excluded, Irish taxation as a proportion of GDP is marginally lower than the European average. There is a fair case, however, given the large impact of profit flows of multinational firms on Irish GDP that GNP may be a more relevant measure. Some of these profits are taxable, however, and to reflect this we use the Fiscal Advisory Councils suggested hybrid GDP/GNP measure as a benchmark. By this measure Irish taxation is slightly above the European average, 9th out of 28 countries.

On the other hand, public expenditure in Ireland is equivalent to that of other countries across the board; with the exception of our demographic linked expenditure on pensions. The absolute sum of the difference between Irish government expenditure and that of other European countries is accounted for by lower expenditure on pensions. This is because Ireland has by far the youngest population in Europe – only 12.6% of Ireland's population is over the age of 65, compared with almost 20% in most other Western European countries. In addition, it is worth noting that Ireland's current expenditure on services is ahead of the European average, while capital investment is significantly lower.

It is clear that public spending in Ireland is sufficient to fund services to higher than European average levels and that core taxation (that which funds public services) excluding SI is above European average levels also. From Ibec's point of view, any calls to increase this spend further must be based on a clear economic rationale such as increasing underfunded capital or R&D investment or subsidising activities which are complimentary to a properly functioning labour market such as childcare, housing or education.

Other developed countries with an Anglo-Saxon social model typically have taxation (including SI) in the region of 1/3rd of GDP over the long term. The UK, Canada, Australia, and New Zealand have had a tax to GDP ratio of 32% since 1990. Ireland's equivalent ratio was 30% in 2014. Our view is that tax on economic activity should remain relatively stable near these levels. Reform of taxation should focus on altering the composition of this taxation away from labour and onto less distortive taxes.

Figure 2: Total tax (excluding social insurance), % of GDP



Our SI system, however, will need to change to deal with the strain it will come under in the future. Ireland's record of pension coverage is demonstrably poor. In recent years our favourable demographics, when compared to most developed countries, has allowed us to put our pension's problems on the long finger. This grace period is now, however, coming to an end. Currently we spend 6 percentage points of GDP less than the European average on pension provision; this gap will necessarily narrow as our population gets older. If this issue remains unresolved into the medium term it risks doing serious damage to our consumer economy leaving a generation with substandard pensions coverage and an unsustainable bill for the state. In this context Ibec has advocated the introduction of a universal pension scheme as part of our SI system for workers with poor coverage.

With this in mind, moves to abolish the USC are a step in the wrong direction to a more efficient tax system. The USC is an efficient tax, captures a broader base of income and is the only tax on income a large proportion of workers' pay. Putting aside the annual revenue of over €4 bn, its abolition would narrow the tax base even further putting more pressure on smaller numbers of people for the total income tax take.

It makes little sense to abolish the USC or remove further workers from it only to attempt to re-introduce a similar tax in the form of a universal pension scheme in the future. A proportion of the USC should be converted to a universal pension scheme in the term of the next government.

The burden of taxation

In recent years the income tax share as a proportion of total taxation has shifted upwards significantly. Income taxation in Ireland, at 40% of total taxation, is the 5th highest in the EU. This shift is far from ideal. There is a weight of evidence which shows that excess labour taxation slows economic growth through its negative effects on productivity and labour market incentives. Recent work by the Department of Finance (O Connor, 2013) and the OECD (2010) have shown that there are potentially significant benefits for Ireland, through increased growth and employment, in shifting the burden of taxation away from earned income and onto less distortive areas such as immovable property or user charges.

Some of this shift will happen naturally over the coming years as recovery in the consumer economy and asset prices leads to greater revenue from consumption and capital taxes. Over the long term we think that income tax should account for around 1/3rd of the total tax base.

Ireland's income tax system is unique internationally, in a number of ways, when it comes to the distribution of its burden among different income groups. Firstly, it is extremely progressive; the most progressive in the developed world. Even allowing for other less progressive taxes such as VAT (which is distributionally flat when measured as a % of household expenditure) Ireland's tax and benefit system remains by far the most redistributive in the EU.

Table 1: Government expenditure, main aggregates, % of GDP

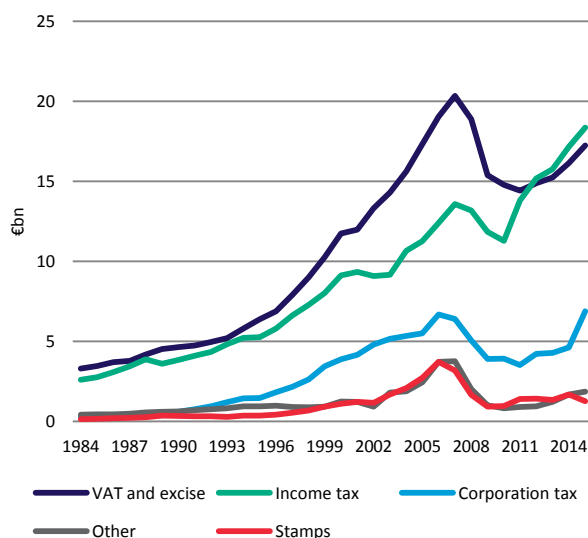
	EU average	Ireland (IFAC hybrid)	Diff (+/- percentage points)
Total	48.6	43.5	-5.1
General public services	6.8	7.2	0.4
Public order and safety	1.8	1.7	-0.1
Economic affairs (incl transport)	4.3	3.3	-1.0
Health	7.2	7.6	0.4
Education - of which:	5.0	4.4	-0.6
(1) Pre-primary and primary education	1.6	1.9	0.3
(2) Secondary education	1.9	1.6	-0.3
(3) Tertiary education	0.8	0.5	-0.3
Social protection - of which:	19.6	16.8	-2.8
(1) Sickness and disability	2.8	3.4	0.6
(2) Old age	10.4	4.4	-6.0
(3) Family and children	1.7	2.8	1.1
(4) Unemployment	1.6	3.3	1.7
(5) Housing	0.5	1.0	0.5

State intervention in Ireland lowers the Gini coefficient of measured inequality by 35%, compared to an EU average reduction of 15.7%. This heavy lifting done by the tax and transfers system is a result of Ireland's high household joblessness, its relatively low employment rates and its narrow income tax base. As various bodies have acknowledged, however, this massive redistribution does not come without both economic and social costs. A balance must be struck between equity and efficiency; from a business point of view the Irish tax system is less efficient than it could be.

The narrative of Ireland as a low income tax country depends heavily on what type of household you live in. The best way to illustrate the progressivity of the overall system is contained in Figure 4 which shows the net benefit or contribution (through direct tax and benefits) to the exchequer by the average household in each income decile. On aggregate only the top three deciles are net contributors to the exchequer, while households in the bottom seven deciles on average receive more from the state than they pay in taxation.

The narrowness of the income tax base in Ireland is a particular feature of our system. This means that the balance of the burden for the state's tax takes falls on a relatively small number of households. Under Ireland's tax credit system 32% of all income tax cases (either single or jointly assessed) end up paying neither income tax nor USC. This compares poorly with our nearest neighbour the UK, where only 11% of income earners are exempt from income taxation. In order to correct for the narrowness of our income tax base, there is a very quick shift upward in effective and marginal tax rates for earners at just above the average wage.

Figure 3: Irish tax receipts by source, 1984 - 2015

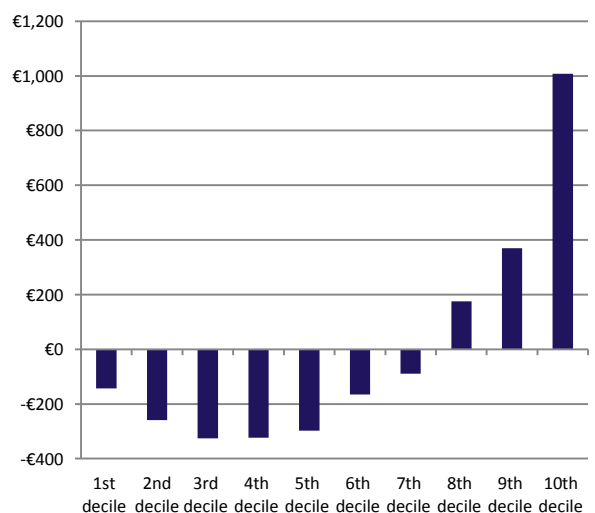


Ireland is also an outlier in terms of its low taxation on low income earners with a person on €25,000 paying about 2/3rds of the average tax for similar earners in other developed countries and less than 40% of their equivalents in countries such as Germany or Denmark.

At just below the average wage (€35,700) Irish effective tax rates begin to rise very quickly as a result of a marginal tax rate of 49.5%. This is the 2nd highest in the developed world at average earnings and kicks in at a level which is the lowest in the OECD (barring some flat tax regimes). At earnings of 120% of the average wage or just above €39,000, Ireland surpasses the OECD average effective income tax rate. The effective income tax rate for a person earning 167% of average wage (equivalent to around €55,000) is the 8th highest income tax rate in the developed world. By 250% of average wage (€81,500) Ireland has the sixth highest average income tax rate in the OECD at 34.6%, five percentage points higher than the OECD average.

The high marginal tax rates necessitated by the extreme progressivity of our system undoubtedly have distortive effects. Large cohorts of workers face marginal rates of almost and over 50%. This is a real challenge for Irish firms creating high value jobs and rewarding skilled workers. The major challenge for the next government, from a business point of view, is how to face these labour market challenges within the constraints of growing spending pressures and a restrictive fiscal treaty.

Figure 4: Net average weekly household direct exchequer contributions by net disposable household income deciles, 2014



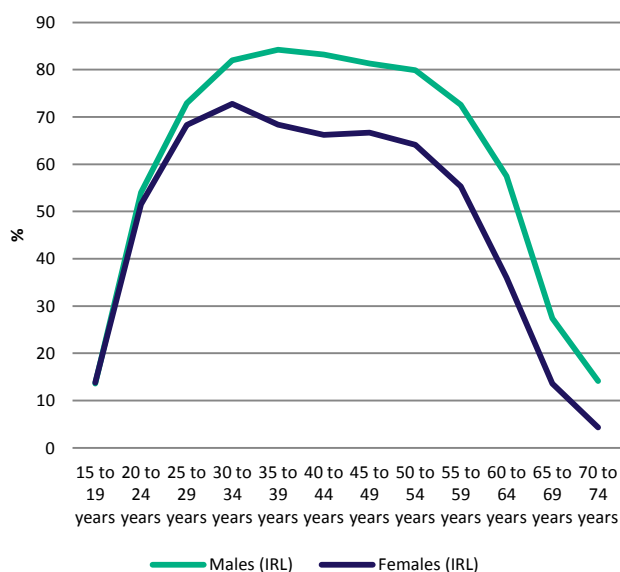
Tax and the labour market

It is widely acknowledged that labour market decisions are sensitive to marginal and average tax rates. This is particularly true for young people, second earners, women with children and persons nearing retirement. The obvious effect of the marginal cost of working (including childcare and taxation) can be observed in the permanent drop off in female employment versus male employment between the ages of 29 and 39 (Figure 5).

From a business perspective there are a number of challenges posed by Ireland's high marginal rates on relatively low incomes. High marginal rates have a significant impact on work incentives for a large swath of workers. They disincentivise workers from taking on additional hours, training or duties. Additionally, they play a significant role in disincentivising work completely for young mothers and second earners. Finally, high marginal rates make it difficult to attract skilled workers in a highly competitive global labour market.

Some commentators have in the past based opposition to reductions in marginal tax rates on the notion that it would only benefit 18% of taxpayers. This misconception is common but untrue and given that the median wage (which by definition 50% of earners must earn above) is just above the entry point to the top rate of tax is evidently mathematically impossible.

Figure 5: Employment rates by age, %



This analysis is based on poor understanding of Revenue Commissioner's data. Revenue regards taxpayers whose tax liability at the 49.5% rate is less than the value of their tax credits as being standard rate taxpayers. This definition makes little economic sense, however, given that earners in this group pay the top marginal rate on a significant amount of their income. A single workers basic tax credits are worth up €8,250. As such, Revenue regard no single earner earning less than €42,050 as being a marginal rate taxpayer despite the fact that they do pay the marginal rate of income tax on at least 1/5th of their income.

The reasons behind this have been outlined in detail by both the ESRI (2011) and Ibec (2013). When this is corrected for in our own and ESRI analysis it is clear that around half of all taxpayers pay at the top marginal rate of income tax. As such the disincentive effects of the high marginal rates of taxation in Ireland are a major labour market issue.

Analysis from the EUROMOD model of tax and benefit changes allows us to measure what fraction of a 3% pay increase for an average worker will be taxed away by the combined effects of tax increases and benefit withdrawals. Figure 6 shows that Ireland has the highest marginal effective tax rate (METR) for both average and median earners in the EU at 50.6%. This means that for an average earner the effect of our tax and benefit system will reduce any pay increase they receive by over half. This is over 15 percentage points higher than for a similar worker in the UK and 18 percentage points higher than for workers in Sweden or France.

In addition, when compared with workers in the UK more Irish employees face these high METRs. Comparative figures from two studies by the ESRI (2011) and the UK's Institute for Fiscal Studies (2015) show the distribution of METRs across the working population. The majority (over 60%) of UK workers face an METR of between 30% and 40%. The largest cohort of Irish workers on the other hand faces METRs of between 50% and 60%. Only 12.4% of UK workers face losing more than 50c from a €1 pay increase; the same figure in Ireland is 39%.

These high METRs are particularly an issue for second earners whose labour market decisions are much more sensitive to tax and benefit changes. European Commission work on gender equality shows Irish second earners facing some of the highest METR's in the EU along with similar workers in Belgium and Germany. This means that many second earners will lose out on a substantial part of their additional pay from either taking up work or taking on more work. This is before additional costs of taking up work such as childcare (which are amongst the highest in the OECD) are taken into account.

This may go some way to accounting for the fact that employment rates amongst women in Ireland, who make up a large proportion of second earners, remain amongst the lowest in Western Europe and is also a major issue in gender earnings gaps in Ireland.

The concentrated burden of taxation in Ireland also has impacts on the ability of companies to attract mobile skills and retain or reward high productivity workers. Attracting skilled workers is increasingly important for business, particularly in FDI intensive economics such as Ireland. Efficient tax policy has a central role to play in this. Investment decisions are made more often than not by individuals who will live, work and pay taxes in Ireland. As such, levels of personal taxation play a key role in attracting key individuals and projects to Ireland.

Recent research in Denmark has provided clear evidence that mobile skilled workers are affected by marginal tax rates at the top of the earnings distribution (Kleven et al, 2013). The evidence points to a 1% increase in the marginal tax rate reducing inward migration of high skilled workers by between 1.5% and 2%.

In addition, marginal tax rates have been shown to effect educational investment for all age groups. The low cut in point and high marginal rates in the Irish tax system in particular reduce the return from investment in education and skills Irish workers can expect. For a worker at the average wage high marginal rates mean that more than half of the financial benefits from taking on continuing higher education are taxed away.

Given that there are clear negative economic consequences to maintaining high marginal rates on work their continuance could only be justified on the social grounds that the proceeds from higher taxes can be redistributed into better services. Comprehensive research, in recent years from the UK, however, suggests that marginal rates at levels seen in Ireland may not be revenue maximising at all.

The Mirrlees review of taxation in the UK suggested a revenue maximising top marginal rate (including indirect taxes) of 56% between €1 gross pay and consumption of that gross pay – or in other words between getting your pay-check and spending it. This in an Irish case would include income tax, USC, PRSI, VAT along with other indirect taxes depending on how you spent your money. Given that revenue figures suggest the average rate of VAT on consumption to be 15% then it is likely that well over half of workers in Ireland are facing marginal rates well in excess of 65% on the same income.

Assuming similar results in Ireland this would imply that a reduction in Ireland's top marginal rate of income tax (the €70,000 rate band) to 45% would result in very little loss in revenue at all. An Independent analysis of similar tax changes in the UK by both HMRC and the independent Office for Budgetary Responsibility concluded that little or no revenue was lost by reducing the top rate of tax to 45 percent in a similar fashion.

Figure 6: Median marginal effective tax rates (METR), 2008 – 2013, %

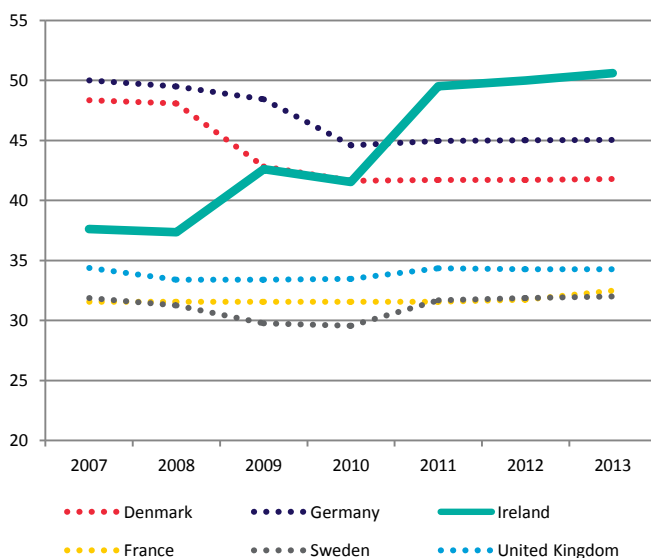
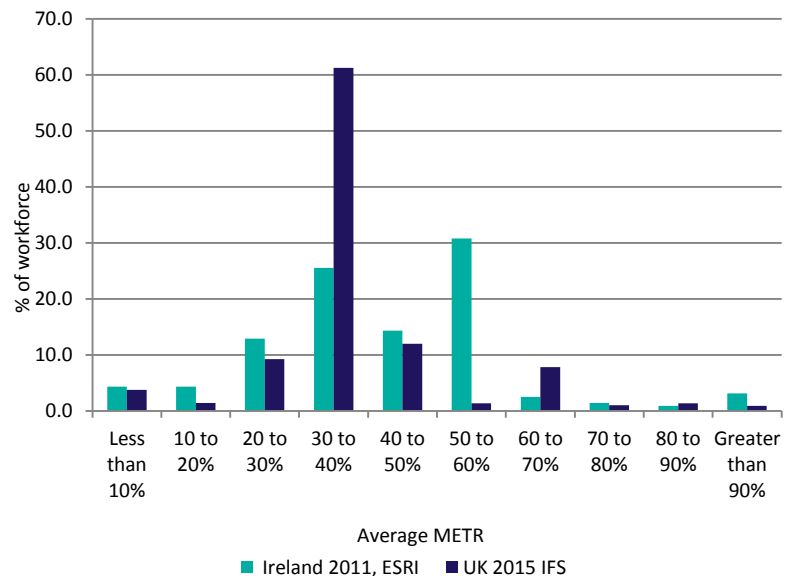


Figure 7: Distribution of marginal effective tax rates (METR) in Ireland and the UK



Conclusion and recommendations

The policy debate on taxation of labour has thus far had a very narrow focus on the distributional impact of changes only. Reform needs to take a broader view based not only on equity but also economic efficiency. In this policy brief we have set out Ibec's views on what reform of the Irish income tax system should look like.

We found:

- **Ireland is an above average income tax economy with a social insurance (SI) model of low rates but high redistribution.** Core taxation (that which funds services such as health and education) in Ireland is slightly above the European average, 9th out of 28 countries. We do, however, pay less SI than average. Simple comparisons as a proportion of GDP do not reflect the stark structural difference between different models of SI. Higher social contributions in other European countries benefit those who pay into them directly. They are not redistributive and are in some cases, for example Sweden's pension system, regressive. The Irish system levies lower rates overall but redistributes those benefits to poorer households.
- **Ireland government spending adjusted for demographics is above the European average.** The absolute sum of the difference between Irish government expenditure and that of other EU countries is accounted for by lower expenditure on pensions. This is because Ireland has by far the youngest population in Europe. Ireland spends above the European average on health and working age benefits. However, we spend below the EU average in education and investment.
- **Tax on work has increased significantly in recent years and is economically damaging.** Income taxation in Ireland, at 40% of total taxation, is the 5th highest in the EU. This is far from ideal. There is a weight of evidence which shows that excess labour taxation slows economic growth through its negative effects on productivity and labour market incentives.
- **Ireland's higher marginal income tax rates at average incomes are a big labour market issue.** About 50% of Irish workers' pay the top marginal rate of income tax. This means that while only 12.4% of UK workers face losing more than 50c from a €1 pay increase through tax and benefit withdrawals; the corresponding figure in Ireland is 39%. This is causing serious issues for Irish employers in rewarding and incentivising workers.
- **Ireland's tax base is excessively narrow with only the top three household income deciles net contributors to the state.** Under Ireland's tax credit system 32% of all income tax cases end up paying neither income tax nor USC. This compares poorly with our nearest neighbour the UK, where only 11% of income earners are exempt from income taxation. Abolishing the USC would exacerbate this and would be a mistake when a solution to the state's looming pension's crisis is needed.

We recommended:

- **The total tax burden share in the economy currently is broadly about right and should not exceed 1/3rd of GDP over the coming years.**
- **Increased expenditure should be based on a clear economic rationale** such as increasing underfunded capital investment or subsidising activities which are complimentary to a properly functioning labour market such as childcare, housing or education.
- **Plans to increase labour taxation further through either income tax or employers' PRSI contributions would be damaging to employment growth.** Revenue buoyancy and base broadening measures should ensure labour taxation only constitutes about 1/3rd of overall revenue.
- **The income tax system should be broad based with top marginal rates (inclusive of USC and PRSI) of no more than 45%**
- 50% of workers' already pay tax at the 49.5% marginal rate or above. **The entry point to the top marginal rates should be linked to above the average wage (currently €35,700) to avoid fiscal drag as wages increase.**
- **Abolishing the USC would be a step in the wrong direction to a more efficient tax system** given that it is the most efficient of taxes, captures a broader base of income and is the only tax on income a large proportion of workers' pay. Putting aside the annual cost of over €4 bn, its abolition would narrow the tax base even further putting more pressure on smaller numbers of people for the total income tax take.
- **Rather than abolition, part of the USC should be converted to a contribution for workers to a defined contribution based pension scheme** as outlined in Ibec's submission on universal pension coverage.

About the author



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Gerard Brady is the Senior Economist in Ibec, Ireland's largest business representative organisation. His role involves engagement with policymakers on issues of importance to business and helping business navigate economic issues. Prior to joining Ibec Gerard worked as a lecturer in economics in University College Cork. He was the winner of the Foundation for Fiscal Studies Miriam Hederman O'Brien prize for research on fiscal policy in 2013.