The Agenda for Tax Reform: Playing to and developing our strengths

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[1] **We are associated with a number of organisations. It would be surprising if the views and opinions in this paper differed substantially from the policy positions taken by these organisations. Where differences do arise they should not be attributed to anybody or to any organisation other than to ourselves. We wish to acknowledge help in preparing this paper from Anne Connolly, Joseph Curtin, Adrian Devitt, Mick Lucey and Eoghan Ó Briain. Any errors are our responsibility.**

Introduction

The setting up of the Commission on Taxation (which is to report no later than 30 September 2009) provides an opportunity for a coherent, considered and structured debate on tax policy. The Commission is now well underway with its work. We look forward to its report providing a framework for future policy decisions by Government. In anticipation of the report of the Commission we set out some ideas and proposals which we hope will contribute to the debate and to the work of the Commission. Our proposals are not a response to the current economic difficulties or a last minute pre-Budget submission. Our focus is on medium and long term structural change.

As we see it the Irish tax system has contributed positively in very substantial respects to the development of the economy – particularly during the last decade. The economic and fiscal position and circumstances are very different to those which faced the previous Commission on Taxation, chaired by Dr Miriam Hederman O Brien[2], when it was established in 1980 and indeed which faced the Governments which were confronted with the challenges of considering and implementing the recommendations of that Commission. Nonetheless, despite the progress made we believe that substantial reforms will be required in order to enable Irish society to successfully address the economic and social challenges of the next quarter century.

Our key assumption

Contributions to the debate on taxation policy generally reflect a variety of concerns and interests – for example climate change, equity and fairness, costs and incentives for enterprise etc. Our contribution is premised on the need for the taxation system to support and enhance the **competitiveness** of the economy. We are not insensitive to other view points. Rather we take the view that enhancing competitiveness is an overarching or transcending requirement for taxation policy and that it provides the only sustainable basis for social progress and for achieving a wide range of social objectives.

Competitiveness

Our definition of competitiveness is that used by the National Competitiveness Council (NCC) - which views competitiveness as *encompassing all those factors which impact on the ability of firms in Ireland to compete on international markets in a way which provides our people with the opportunity to improve their quality of life*. The inclusion in the definition of *the need to provide our people with the opportunity to improve their quality of life* ensures that the concept is not just a narrow one of cost competitiveness **at all costs** (of the so - called *Race to the Bottom* variety) . This and the emphasis on international markets (which of course includes the Irish market) aligns *the* concept with the essential criterion of comparative advantage – maximising value added through trading to our strengths and at the lowest opportunity cost. Ireland is in a *Race to the Top*

[2] Donal de Buitléir was Secretary of the Commission from 1980 to 1985. The five Reports of the Commission are available on www.fiscal.ie

Why is competitiveness a transcending requirement for taxation policy?
An obvious answer to this question is that the resources (including public expenditures) required to support our standards of living and to fund public services will be determined by our competitiveness – and more particularly the extent to which this competitiveness is based on the sale of high value added goods and services. Our ability to successfully sell high value goods and services on international markets is an essential foundation for prosperity. But there is also a synergy between the requirements of competitiveness in a high value added economy and many of the priorities of social policy.

For example, enhancing competitiveness is consistent with other important requirements such as quality of life and equity.

Quality of life
People with high levels of education and skills (i.e. knowledge workers) are key determinants of competitiveness. They also enjoy higher than average incomes and are generally in high demand – whether as employees, owner –proprietors, investors or self employed. Many are mobile and have strong preferences for living in pleasant environments with good housing, education, social services, health and other public services such as public order, transport, water supplies, air quality measures, communications and physical infrastructure.

Equity
High value added competitive economies are also complex. Strong levels of social cohesion are important in underpinning the necessary complexity in a competitive society. Social cohesion is enhanced when the tax system is perceived as not just rewarding enterprise and initiative but also as being socially just. The precise degree of distributional equity in taxation delivered or aimed for (and there are big differences between the two) is of course a matter of political choice. But, however, it is unlikely that a tax (or indeed an overall fiscal system) which does not meet generally accepted standards of fairness will enhance competitiveness. In this last respect we see our analysis as being largely in accord with the views of the Hederman O Brien Commission

Key principles
The first report of the Hederman O'Brien Commission on Taxation published in 1982 identified **equity, efficiency** and **simplicity** as the key essential criteria against which a tax system should be judged. In our view these are enduring principles – though needless to say subject to evolving interpretation with changing times and circumstances. This is particularly so for the **efficiency** criterion. The Hederman O'Brien Commission noted the conventional economic view that individuals and businesses when left to their own devices will make the most effective use of economic resources which points to the minimisation of taxation levels and neutrality in taxation. The Report did recognise the need to have regard to externalities (climate change being an important present day example) would justify departures from neutrality. They concluded that:

"It is now widely accepted that the level and pattern of taxation should be determined in such a way as to help regulate the level, direction and rate of change of economic activity, with particular reference to the growth of production, real incomes and employment, the stabilisation of costs and prices and the control of the balance of payments. A good tax structure must be

flexible so that the total receipts from taxation can be adjusted fairly rapidly and frequently. At the same time, there is a clear need for certain stability in taxation in order that taxpayers can make reasonably long-term plans. Uncertainty breeds lack of confidence and is a serious impediment to production and prosperity. There is an obvious clash between these requirements. The solution would seem to lie in avoiding frequent and fundamental changes in the whole tax structure which, in turn, depends on finding a structure of taxation which is broadly acceptable to different tax objectives from time to time." (Paragraph 3.9 of first report of the Commission on Taxation).

We broadly endorse these conclusions - subject to emphasising that the structure (burden, rates, composition and incidence) of the tax system should support and enhance competitiveness and exports. Thus there is a case in our view for ensuring that the structure of the tax system encourages investment and activity in the traded sector. There are also implications for incentives and tax expenditures.

1) Incentives should be strictly limited as each additional one dilutes existing incentives.

2) Incentives directed towards the sheltered sector should be avoided except where they address market failures in key areas of policy concern such as pollution and greenhouse gas emissions. Incentives distort economic decisions and where they divert investments away from the traded sectors they are generally wasteful. Applying this logic to current preoccupations about the housing and property market, we take the view that taxation incentives directed at stimulating housing construction will not only be wasteful (by encouraging the misallocation of resources) but that they will also slowdown the necessary adjustment in housing prices[3] . Even in terms of their own immediate objectives (of stimulating the housing market) they will be futile.

3) Incentives should only be used for addressing market failures which constrain competitiveness – the stimulation of R&D and encouraging individuals and companies to invest in education and training are areas where carefully designed tax reliefs could play an important role.

[3] Lower house prices confer economic and social benefits by enhancing affordability. Demand for housing will increase when potential purchasers are convinced that the downward adjustment is complete.

Structure of the tax system – and the effect of taxation on economic performance

The current Commission has been asked to examine the balance between income, consumption and capital taxes.

Taxes vary in their economic effects. There is an extensive theoretical and empirical literature on the economic effects of taxation, some of which can be difficult to use as a guideline for policy but there are a number of broad conclusions which can be drawn.

Income taxes can affect both labour supply and demand. Lower taxes on employees increase the demand of firms for labour and labour market participation is encouraged by lower tax rates. The lower the tax wedge (i.e. the difference between the costs of labour to an employer and the take home pay of the employee) the more positive the effect on employment. The impact of income taxes on peoples' decisions to work is ambiguous due to competing income and substitution effects. Circumstances also matter – for example, second earners in families can be particularly discouraged from taking up paid employment by increases in marginal tax rates. The impact of progressive taxation on decisions to invest in education would also appear to be negative to the extent that higher marginal rates discourage personal decisions to invest in higher education (whether by direct expenditure on fees or by way of deferred earnings and leisure forgone).

Consumption taxes, particularly **VAT** are thought to have a less negative effect on economic performance than income tax because they do not distort decisions to work or to invest. VAT has a neutral impact on exports because it is levied in the country of consumption or destination and the VAT on inputs is refunded on exports. Economic theory and analysis suggests that differentiated tax rates which are often used as measure to reduce income inequality (e.g. zero rating of VAT on basic groceries) are ineffective as policy instruments. Producers and retailers can shift the practical incidence of the tax and higher income households tend to consume relatively more of the low-taxed goods and thereby benefit more from the lower rates. Direct income payments to low income households are more effective as policy instruments for addressing income inequality.

The economic impact of **Property Taxes** is very interesting – and suggests a sharp divergence between what is economically desirable and tax policy in practice.

1. Recurring annual taxes on land and buildings (particularly residential property) are generally thought to have minimal negative effects on economic performance. This arises because a recurrent tax particularly on residential property is a fixed sum. It has a zero marginal rate and, other things being equal, does not negatively effect decisions to whether or not to seek work or to invest in further education or in business expansion. The tax base is also stable and predictable. Another attraction from a government point of view is that recurring taxes on property are difficult to avoid or evade because the tax base is so visible. This last feature may explain their apparent unpopularity.

2. In contrast, taxes (such as stamp duties) on property transactions (both on real property and on financial and capital transactions) are highly distortionary – by for example reducing liquidity in the housing market. The yield is also extremely volatile.

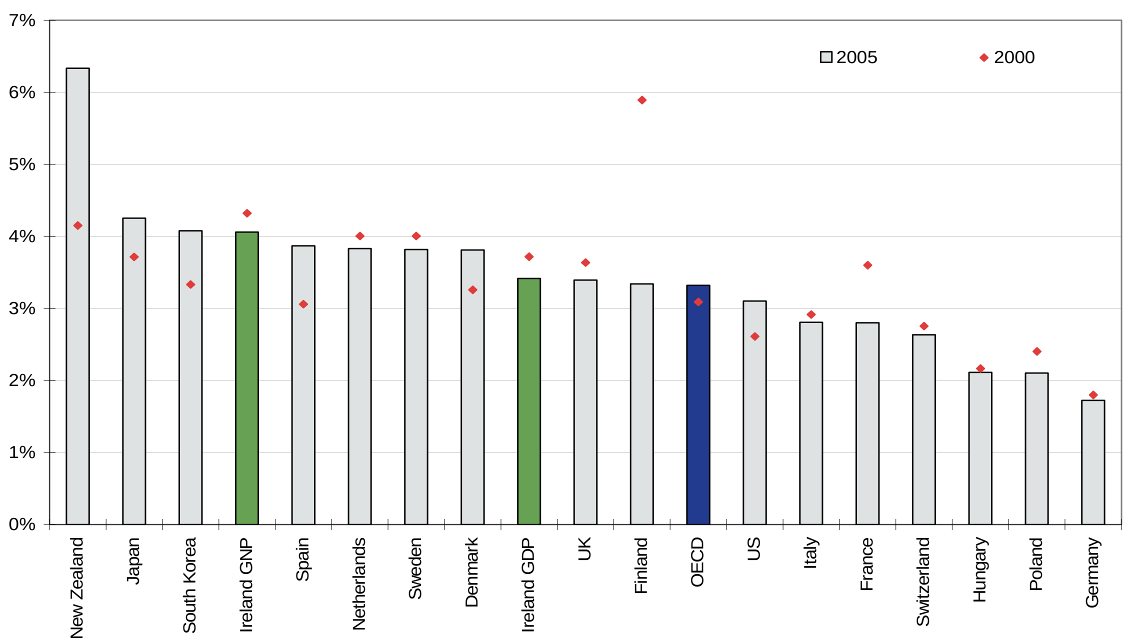
3. Inheritance taxes have little distortionary effect.

The increased openness of countries to international trade and investment also has implications for tax design in a competitive, globalised world. For example, differences in income tax rates may influence workers, particularly highly paid ones, as to where they choose to live and work. High rates of VAT and excise duties through their general impact on the overall price level may damage competitiveness, discourage inward tourism and encourage cross border shopping in lower tax jurisdictions.

In summary, economic theory and empirical research suggest that as a general principle, and all other things being equal, lower tax rates should encourage economic activity. However, this conclusion needs to be tempered (even from a narrow economic perspective) by the need to raise tax revenues to fund the public goods (such as education, health, social services, transport, and public order) which are essential in a modern economy and society.

The Commission has not been asked to review the rate of **Corporation Tax** in the light of the guarantee given in the Programme for Government. In an era of mobile foreign direct investment the low rate of Corporation Tax is an important competitive advantage for Ireland. It has also stimulated tax revenues. Ireland earns more in corporation tax revenue as a % of GNP than most OECD countries – see Figure 1

Figure 1: Corporation tax receipts as a percentage of GDP 2005

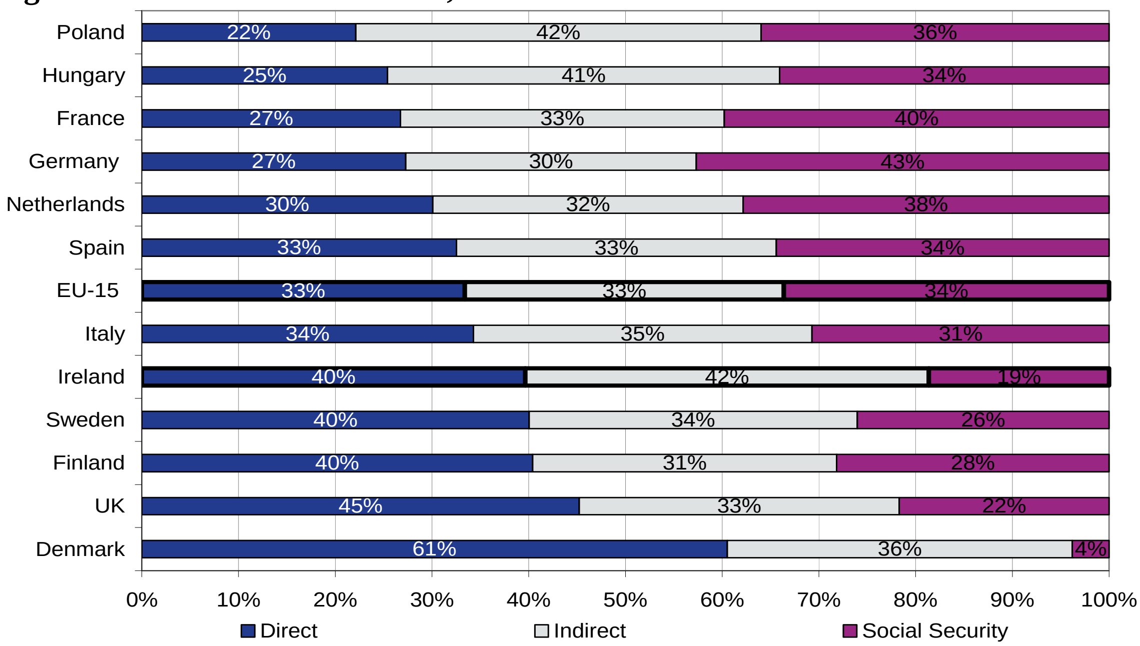


Source: OECD, Revenue Statistics 1965-2006

How does Ireland compare? The balance between taxes collected on income, capital and consumption

Figure 2 shows a comparison of the breakdown of tax revenue by tax type in OECD countries.

Figure 2: Breakdown of Revenue, 2006



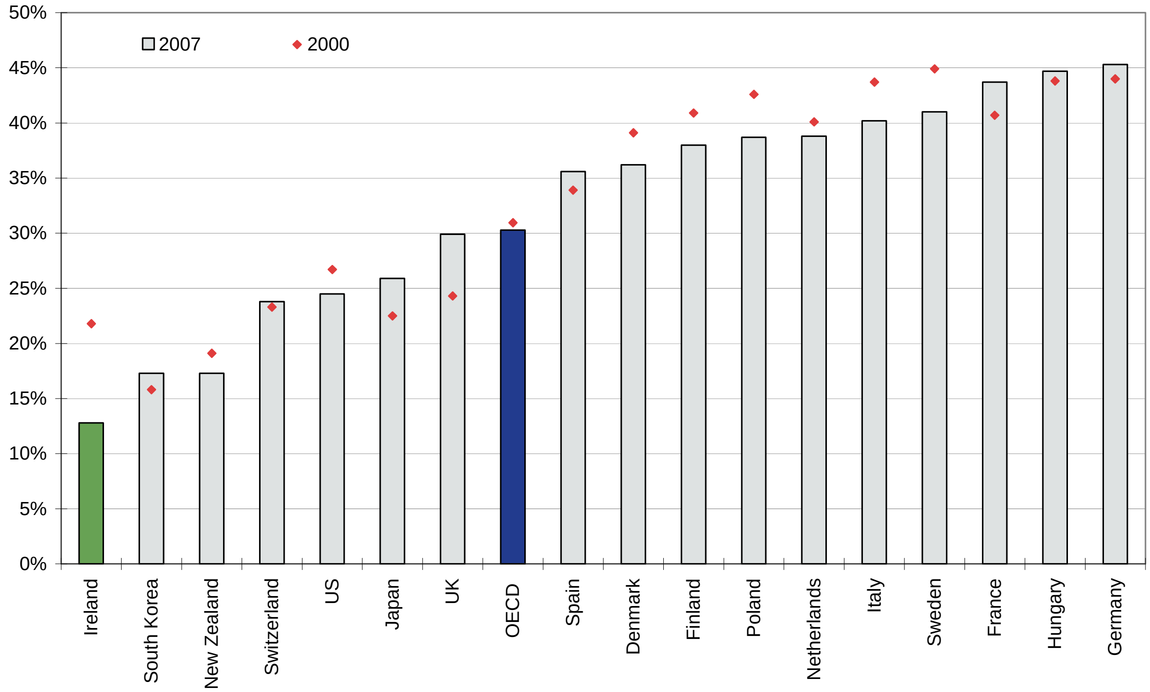
Source: Eurostat, Economy and Finance Indicators.

The chart highlights a relatively high reliance on indirect taxes (VAT and excise taxes), low social security contributions. We also have a low proportionate yield from recurrent taxes on property which is not shown in this chart.

The top marginal tax rate in OECD countries in 2007 averaged 42.6 per cent. It ranged from 19 per cent in Slovakia to 59.7 per cent in Denmark. . The Irish top rate is mid range but it applies to single persons at less than half the relative income level in OECD countries. On average the top rate in OECD countries applies at 2.5 times average earnings.

Figure 4 compares the tax wedge on labour as a percentage of average earnings. The tax wedge in Ireland is now the lowest in the OECD at less than half the OECD average.

Figure 4: Total Tax Wedge on Labour (as a % of Average Earnings), 2007[4]

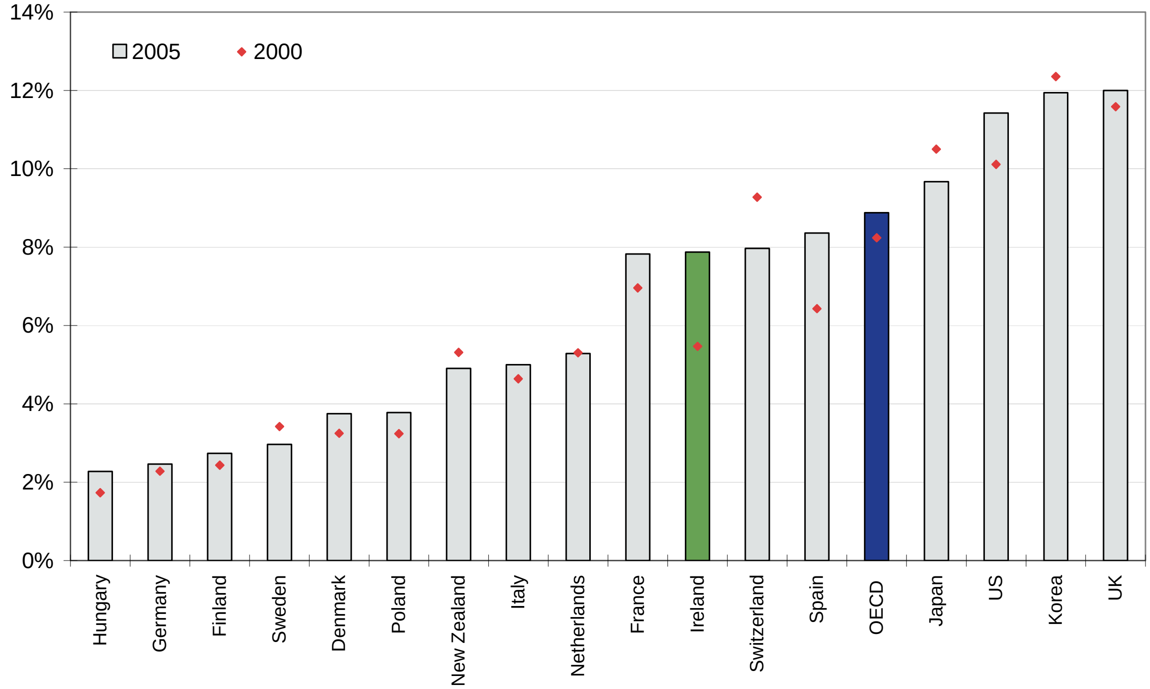


Source: OECD Taxing Wages 2006/2007

The tax yield from property in Ireland is close to the OECD average **(Figure 5). Most of this yield comes from stamp duties.**

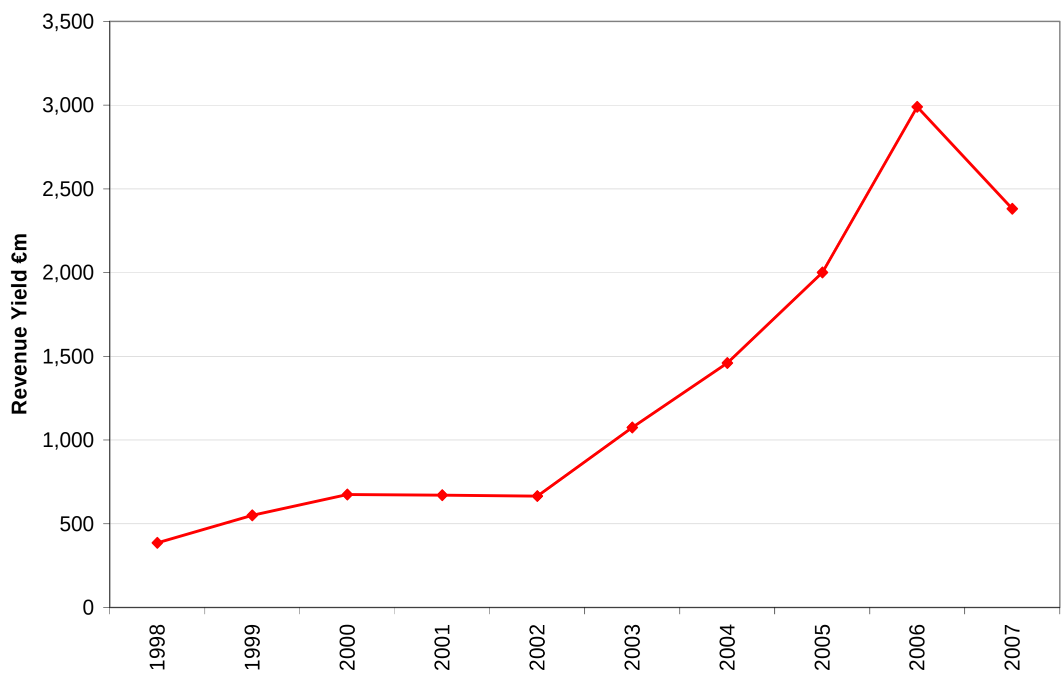
[4] Data based on a two-earner family with a wage level of 100-67% of the average wage.

Figure 5: Property Tax Receipts (as a % of Total Tax Revenue), 2005



Source: OECD, Revenue Statistics 1965-2006

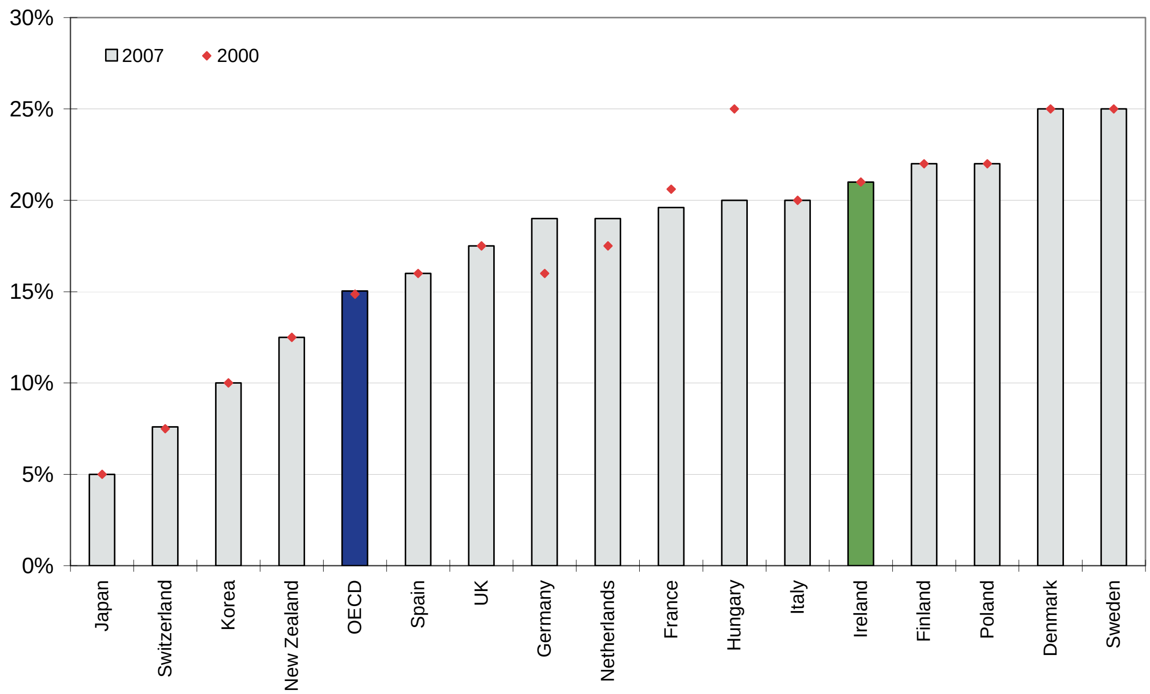
Figure 6: Stamp Duty Revenues (€million)



Source: Reply by Minster for Finance to Dail Question, Number 146, from Deputy Ricard Bruton, Wednesday, 12th March, 2008. Ref No: 10815/08.

The standard rate of VAT is among the highest in the OECD – Figure 7

Figure 7: Value Added Tax, Standard Rate, 2007[5]

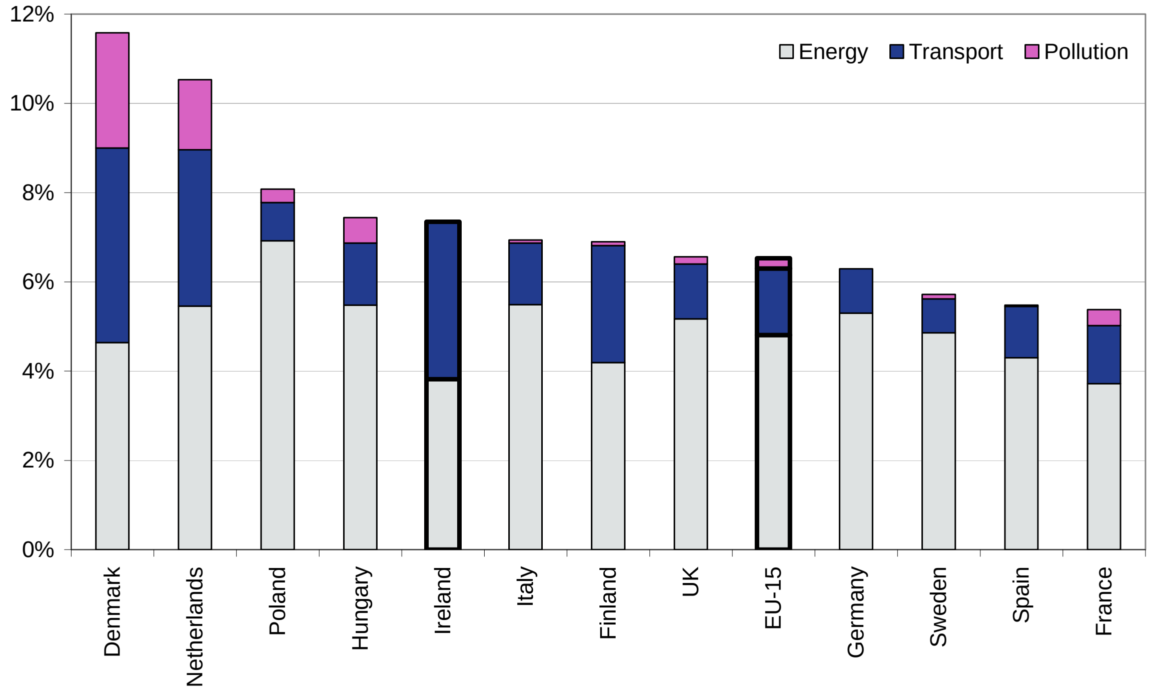


Source: OECD, Tax Database, 2008

Interestingly, in the light of the requirement in the terms of reference of the Commission to investigate fiscal measures to protect and enhance the environment including the introduction of a carbon tax, Ireland collects a relatively large proportion of its tax revenue from environmental sources, but we do not tax pollution explicitly as other countries do. The share of revenues from taxes on energy is also about average.

[5] OECD-28 average minus US.

Figure 8: Use of Environmental Taxes by Type (as % of Total Tax Revenue), 2005

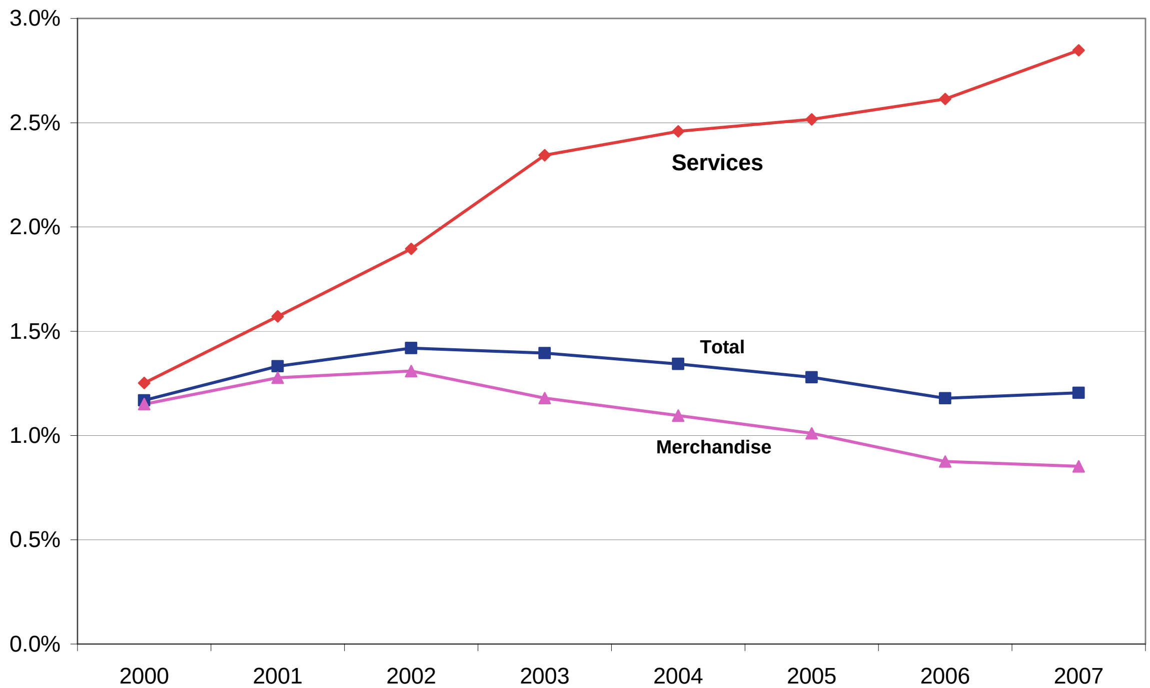


Source: Eurostat, Environment and Energy Indicators

Tax and the competitiveness score card

1. The low rate of Corporation Tax is an important competitive advantage and also generates a substantial yield. However the treatment of important sources of competitive advantage such as R&D and the approach to intangible assets (e.g. brands, software, copyright etc) does not adequately reflect the requirements of a knowledge based economy and the growing importance of the services sector (particularly in relation to export earnings – see Figure 9 showing the evolving composition of Irish exports)

Figure 9: Ireland's Share of World Trade: Overall, Merchandise and Services (%), 2000-2007



Source: World Trade Organisation

2. The low tax wedge on incomes is also an important competitive advantage. Ireland has the lowest tax wedge in the OECD (Figure 4). Maintaining a narrow gap between the costs of an employee to an employer and the take home pay of an employee is a powerful pro-employment policy.
3. The high proportionate yield from indirect taxes and the high VAT standard rate has a muted impact on personal and corporate incentives to work and invest. But they do contribute to the raising the overall price and cost level (which has now become a significant competitiveness disadvantage). They also have an adverse impact on inward tourism which is an important source of foreign earnings.
4. Stamp duties (particularly on property transactions) are (or have been) an important source of tax revenue. They are highly distortionary on economic decisions, impede mobility and create continuing incentives for tax avoidance – and possibly evasion. They are also as we have shown a volatile source of revenue.
5. The low tax yield from recurring property taxes (and from inheritance tax/ Capital Acquisitions Tax (CAT) is a significant opportunity cost. It contributes to the need to increase yield from indirect taxes and particularly from stamp duties. The historic problem here, of course, was the abolition of local authority domestic rates in 1977. This was not a costless decision. In addition to the pressure it placed for increasing the yield from other taxes it reduced the fiscal autonomy of local

authorities and with that their capacity to respond to local development needs. The only non Exchequer sources of revenue now left to the local authorities are commercial rates and so- called “development charges”. Both add to the costs of doing business. A proportionate transparent tax on business property is clearly defensible but the development charges often lack conceptual basis, are not related to the costs of the service provided and are often seen by businesses as capricious and arbitrary taxes on development.

6. The nominal rate of capital gains tax at 20 per cent is internationally competitive but the abolition of indexation relief in 2003 effectively imposed a heavy stealth tax.
7. The PRSI system is in need of substantial reform. It is unfair, increases the tax wedge at low income levels and is unnecessarily complicated. For example, there are 30 different subclasses of PRSI contribution and the system is very complicated. The employee's portion of the social insurance contribution is paid on earnings up to a ceiling of €50,700. Employees who earn not more than €352 in any week are exempt from paying PRSI for that week. There is no annual refund payable to employees whose weekly earnings fluctuate above and below the €352 exemption limit.

   The weekly (non-cumulative) PRSI-Free Allowance for employees with weekly earnings in excess of €352 is €127 per week. (This allowance does not apply to the Health Contribution and it does not affect the employer's contribution).

Health Levy

People between the ages of 16 and 70 may have to pay the Health Levy[6]. The current rate is 2% or 2.5% on earnings above €100,100 a year. Employed people with income of €500 or less in any week are exempt from the contribution in that week. Anyone over the exemption limits is liable to pay the Health Levy on all of their income.

PRSI Rate Structure

There are also illogical kinks in the rate structure arising from step changes in rates. For example; an increase of €1 per week

- From €352 Employee pays extra €9.04
- From €500 Employee pays extra €10.06

[6] Exempt groups include:

- Everyone aged 70 or over
- Medical Card holders (including all those aged 70 or over)
- People who are getting Widow's/Widower's Pension, a One-Parent Family Payment or Deserted Wife's Allowance from the Department of Social and Family Affairs or a widow's pension from an EU country.

- From €356 Employer pays extra €8.12

Our policy recommendations

1. Continue the policy of a low corporate tax rate.

The direction of Irish corporate tax policy has been consistent since the introduction of export sales relief (zero percentage tax on exporting companies) in 1956. The current 12.5% rate has been critical in attracting leading international companies to locate in Ireland. FDI companies account for the greater proportion of exports (both goods and services). Increasingly high value added business functions (R&D, logistics etc.) are being located in Ireland. There have also been substantial less quantifiable benefits. Many of the FDI enterprises in Ireland are now under the direction of Irish executives. This increases the profile and awareness of Ireland in these companies internationally. The FDI also contributed to enhancing the competencies and skills of Irish managers. The low rate policy has also been effective in ensuring (as compared with other countries) a high yield from corporation tax – see Figure 1 showing the comparative contributions of corporation tax (as a % of GDP/GNP). .

We recommend the following reviews of the corporate tax base in order to support the development of a competitive knowledge based economy through investment in knowledge and human capital. These include

a) consideration of the case for tax credits for investment by companies in the participation by their employees in relevant education and training
b) review and, if needed, adjustment of the R&D tax credit scheme – which currently seems to be of limited value to smaller companies. There are also concerns that it is not as competitive as similar schemes in other countries
c) applying similar tax depreciation policies as currently apply to investments in physical capital to expenditures on intangible investments (such as brands, software, copyright and other forms of capital which embed intellectual property and knowledge capital)

The Irish corporate tax regime is under hostile scrutiny from a number of other countries and corporate tax rates are falling internationally. As a result the competitiveness of the tax regime needs to be kept under review.

The European Commission is supporting the adoption of a Common Consolidated Corporation Tax Base (CCTB). Ireland is implacably opposed to this proposal. While the adoption of a common tax base could have advantages in certain cases, these are more than offset by the rigidity that such a proposal would import into the system. Given the requirement for unanimity to make tax changes, a common base if adopted would be very difficult to change in response to changed economic circumstances.

The "Consolidated" element of the proposal would distribute the revenue raised from multinational enterprises through some formula rather than on the current basis of arms

length pricing. The proposal would transfer tax revenues from smaller to larger EU countries.
On these grounds we believe that the CCTB proposal is not in Ireland's interest. Fortunately, it is unlikely to find sufficient support from other EU Member States for it to have any chance of being adopted. However, the Irish Government should continue to monitor developments in this area closely.

2. Maintain a competitive tax wedge

As we have seen Irish employers and employees at the level of average earnings experience one of the lowest tax wedges in the OECD. This is a significantly pro-employment outcome. The wedge (which is the gap between what the employer pays and what the employee receives has consistently fallen since 2000. High tax wedges have the effect of pricing employees (particularly low-productivity and low income employees) out of work. The NCC has argued that some categories of workers still experience significantly higher barriers to participating in the labour force and have urged that the marginal tax rate on second earners should be reduced. The incentives faced by other groups should also be strengthened. These include lone parents. Single workers with no children earning 167% of the average wage also face a significantly higher tax wedge. This group include young, relatively highly skilled executives – who can be quite mobile and responsive to more favourable tax regimes where they exist in competitor countries.[7]

As a general principle we favour, resources permitting, extending the standard rate band in order to address the relatively low income level – particularly on single people - at which taxpayers progress into the higher rate band.

Enhanced incentives to encourage individuals to invest in their own education and training should be considered. Currently, relief (at the standard rate) is available for spending on some tuition fees up to an annual limit of €5000. We recommend making this more attractive – with enhanced but targeted reliefs available for expenditure by individuals on tuition for education and training which relates to improving their work place skills. The determination of eligible courses may be controversial but in our view the enhanced relief should be focused as much as possible.

3. Keep the VAT structure simple and broaden the base

We accept the arguments in favour of a flat rate. It would be non distortionary, more efficient to operate for both the Revenue and for businesses – and would be significantly lower than the current standard rate of 21%. The Irish system has 3 rates which is a marked improvement on the situation prevailing in the 1980s where there were 6 rates. In addition to the standard rate, there is a reduced rate of 13.5% and a zero rate[8]. Both theory and practice indicate that economic efficiency and social justice are best served by having a simple structure. The zero rate on food is an inefficient way of helping less well

[7] See NCC submission to the Commission on Taxation, June 2008. www.competitiveness.ie
[8] There is also a rate of 4.8% on the sale of livestock (i.e. live cattle, horses, sheep, goats, pigs and deer), greyhounds and the hire of horses.

off individuals and families. Better off people spend more on food than their less well off counterparts. Targeted income transfers to less well off families would be much more effective in addressing income inequality. But a complicated tax structure can be more attractive to some policy makers and to special interests - in our view the recent EU proposals to allow member states to increase the number of non-standard rates is an unwelcome development.

The standard rate is among the highest in the EU. Any further increases by increasing the general price level run the risk of deflecting consumer expenditure to other EU countries and to the US as well as discouraging revenue from tourism.

Our policy preference is to see continuing movement towards base broadening and a lowering of the standard rate.

4. Maximise the yield from excise duties on alcohol and tobacco

Taxes on alcohol and tobacco are not just sources of revenue to the Exchequer. They are also instruments of public policy – particularly in regard to health and public order. We are comfortable with a view that excises on alcohol and tobacco should be levied at as high a rate as possible as is consistent with preventing significant revenue leakages through smuggling and cross –border purchases in countries which levy lower taxes on these products.

5. Phase out stamp duties particularly on property transactions – and phase in a recurring property tax

Our suggestion has nothing to do with some of the proposals or suggestions currently circulating in the ether that stamp duty reductions would stimulate the residential property market.

We have already described the negative impacts of stamp duties. We have paid a high price for the abolition of domestic rates in 1977. Indeed, if local authority rates had been reformed to remove some of their more unacceptable features rather than abolished their impact should have contributed to moderating the damaging housing bubble to the extent that the recurring cost of a property tax would have tamed some of the more exuberant tendencies in the property market.

Without a recurring property tax, local authorities have little incentive to encourage more housing or higher density housing. New housing costs them more money for service provision with no financial gain.

A recurring property tax on residences would be very unpopular. This may have something to do with the difficulty of evading a tax on a very visible base and because payment of the tax was traditionally demanded in substantial lump-sums. Nonetheless the objective arguments in favour are persuasive. It does not discourage individuals from increasing their earnings and productivity. Measures such as waivers and deferrals for older and poorer people can be introduced to address some of the features of the tax which might be regarded as inequitable or harsh. In addition, the tax could be collected in instalments through the PAYE and ROS systems. A variety of transitional measures can also be introduced to provide relief for individuals and households who have recently paid large amounts of stamp duty. Income tax credits, deductions or reliefs could also be introduced to address concerns about increasing the overall burden of taxation. There are persuasive arguments for assigning the revenues from property taxes to local authorities – but this should be matched by corresponding reductions in transfers from the Exchequer to these bodies.

There is one area where we would welcome a redistribution of stamp duties. Irish businesses and the public service make extensive use of cheques for payment, although public service organisations are making good progress on using electronic payments. The usage is among the highest in the EU. There is also a relatively high use of personal cheques but not on the scale used by businesses and the public service. Cheques are an inefficient and costly method of making payments. We would like to see an increased stamp duty on cheques with the revenue used to eliminate the duty on debit cards and to reduce the duty on credit cards. These measures would also incentivise the substitution of card payments for cash and reduce the exceptionally high and expensive use of cash by Irish consumers.

6. Capital Gains Tax (CGT)

An important policy change was made in the 2003 budget when it was announced that "*indexation of the base for computation of capital gains will only be allowed to be calculated up to 31 December, 2002*"[9]. This major change was justified on the basis that *"All of these reliefs and allowances made sense when CGT rates were 40 per cent and 60 per cent"*. The other reliefs referred to were roll-over relief and tax deferral through the use of loan notes.

It should be an important principle of tax policy to get the base right before applying the appropriate rate of tax – abolition of indexation distorts the base in a most arbitrary way. It is very damaging in the long-term. It involves a major increase in effective tax rates.

To take a simple example, assume an asset is bought now and that it doubles in nominal value over the next ten years. Assuming inflation is 5 per cent a year, the effective rate of capital gains tax is not 20 percent, not even 40 per cent but 57 per cent. If it doubles in one year the effective rate of tax is 21 per cent.

The abolition of indexation favours speculation. As Kay & King[10] conclude:
"The real losers from inflation are those who make modest nominal gains."

Indexation should be restored even at the cost of increasing the rate of capital gains tax. This would make the effective rate of tax explicit.

[9] Budget Statement, 2003
[10] "The British Tax System, page 49"

7. Health Levy

The health levy should be fully integrated with income tax. Payment of the levy confers no entitlement to health services and makes HSE funding more complicated and less transparent. In addition, those aged over 70 on high incomes who are substantial users of the health service do not pay this levy.

8. PRSI

Our proposals in relation to PRSI are set out in the next section dealing with the tax treatment of savings.

The Tax Treatment of Savings

The Commission on Taxation has been asked to *"consider how best the tax system can encourage long –term savings to meet the needs of retirement"*.

Pensions

Taxation issues are only a subset of the much larger issue of ensuring adequate pension coverage for the population. We face considerable challenges – notwithstanding the contributions which are now being made to the National Pensions Reserve Fund. These challenges are described in the Green Paper on Pensions published in 2007.[11] In broad outline terms the existing system has two components – the State run social welfare pension system and supplementary voluntary pension arrangements. According to the Green Paper the existing system is not sustainable. Some of the underlying factors include increasing life expectancies (good news if you have adequate pension cover), a declining ratio between the numbers in the working population and the numbers of pensioners – although reassuringly the Green Paper projects that the working age population will peak at 29% higher in 2041 than it is today but nonetheless by 2050 there will be only two workers per pensioner as compared with six currently[12] .

Allied to this there are a number of serious challenges facing individual prospective pensioners as the current system will not provide adequate incomes – if we define that at 50% of replacement income.

1) 50% of the workforce will depend on the Old Age Pension alone and of the 50% remaining , 25% are considered not to have adequate supplementary provision.
2) The options for individuals currently at work are to save more, pay more tax (forced savings) and/ or retire later.

[11] Green Paper on Pensions, Government Publications Office, 2007 and http://www.pensionsgreenpaper.ie/publications_greenpaper.html
[12] Green Paper Para 3.4

The challenges at macro/ Government level parallel these. According to the Green Paper the options facing public policy makers are

1) Increase Exchequer contributions
2) Reduce public expenditure on non –pension programmes
3) Increase the retirement age
4) Increase the size of the working population
5) Improve economic capacity and **competitiveness**

The Green Paper points out that we have a window of opportunity to address these challenges. Our view is that in order to avail of this we need a major paradigm shift away from notions of pensions to a new model of life time income /savings and capital accumulation. Tax reform has a role in facilitating this change.

The need for a new paradigm?

Current thinking about pensions is based around a life progression model involving three economic phases beginning with childhood and youthful dependency[13], through the world of work and economic activity and finally to exit from the work force with sharp discontinuities between each phase. This paradigm is rapidly diverging from reality. At the youthful end the earner/learner phenomenon is increasingly replacing the concept of being a full time student and older people, while anxious in many cases to exit full time employment (or their present employer), are seeking opportunities to continue active engagement in society and very often in the world of work. The prospect of every second female child born this year living to be 100 may not be unrealistic. Neither is the prospect that some people born this year will live to be 120. If this turns out to be the case the traditional retirement date, unless changed, will transform from being a later life benchmark to being closer to a half way marker. Between 1970 and 2004 the average number of years of drawing a pension has gone up from 11 in the case of men to 18 and from 18 to 23 in the case of women. At the same time there has been a 25% reduction in the number of years people are working[14].

Otto von Bismarck's concept of an old age pension which would ensure frugal comfort for German employees for the two remaining years of their life after retirement no longer accords with demographic and social reality – yet it influences pension thinking and policies. We see this manifested in many ways:

1) A complex social welfare pensions system with multiple rates of contributions and benefits[15]. There are 9 different contribution classes and up to 30 subclasses.

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[13] According to urban myths now lasting up to the mid 30s!

[14] IBM Global Social Segment, September 1997 .

[15] For example, Class C covers commissioned officers of the Defence Forces and members of the Army Nursing Service recruited before 6 April 1995**;** Class H covers NCOs **and** enlisted personnel of the

The system is not transparent – contributors do not receive periodic statements of their State pension entitlements (which are mandatory in the private sector). The system also abounds with anomalies some of which because they depend on the date of first entry into insurable employment lead to inequitable outcomes – (The Green Paper on Pensions notes (para 5.22) that the level of social welfare pension to which a person is entitled may not reflect the total number of contributions a person has accumulated over their working life. For example, a person with 500 contributions may receive a higher rate of payment than a person with 1,000 contributions, depending on when each person first entered insurance).

2) Limited awareness among younger people of the need to start making pension provision at an early age.
3) Mandatory retirement ages
4) Anomalous rules especially in respect of barriers and obstacles placed in the way of working while drawing pension income. For example, access to the State Pension (Transition) at age 65 requires retirement from work while after age 66 an individual in receipt of the State Pension can work. This prevents people from working or pushes them into the black economy at a critical time for them in managing the transition from full time work.
5) At the level of detail, "Catch 22" issues arise for less well off defined benefit pensioners when the State PRSI pension increases- the private pension benefits are reduced when the PRSI benefit is increased This arises when private sector defined benefit occupational pension schemes are integrated with benefits payable under the Social Welfare system. Most private sector schemes are integrated with the Social Welfare scheme.

Where to?

The consultation process launched after the publication of the Green Paper on Pensions has produced widely divergent views – a cause of some concern for the Minister for Social and Family Affairs[16]. The lack of consensus in not surprising. The system is complicated and is not working properly. Without a paradigm shift in the pensions and savings system which parallels the paradigm shift which is taking place in society and generating new needs, challenges and expectations, it is unlikely that even the most skilful analysis and consultation process will deliver an adequate response. Our proposals for change are influenced in part by the structures and experience of the Singapore Central Provident Fund (CPF). The CPF is a compulsory comprehensive social security savings plan which aims to provide working Singaporeans with a sense of security and confidence in their old age. It is administered by a statutory board under the Ministry of Manpower.

Defence Forces and Class K covers people receiving income that is not subject to social insurance contributions but which is liable for the Health Contribution. Income includes occupational pensions, income deriving from positions of certain office holders (such as judges and state solicitors)**.**

[16] "*No consensus on pension reform*" , Irish Times , Friday May 30, 2008

Proposal - a national savings fund

A statutory fund would be established with three pillars - funded by three scales and proportions of contributions. An important feature of this scheme is that every individual in the labour force would have his or her own unique account with the Fund. Information on contribution details, value and equivalent annualised income values would be regularly updated and available to the account holders.

Pillar 1.

Compulsory contributions from employees, employers, self –employed and farmers, with a contribution scheme broadly similar to the current PRSI system while removing some of the complications and anomalies. Funds in this tier, which may need to be supplemented by Exchequer contributions, would be used to fund a basic income for pensioners similar in concept to the current contributory pension. A non-contributory pension scheme would remain in place as a safety net, anti-poverty measure.

Pillar 2

"Soft"[17] mandatory or auto-enrolment contributions from employees and employers according to specified scales[18] to the individual accounts. Exchequer counterpart contributions (modeled on the SSIA and PRSA schemes) would be paid into the Fund proportionate to the employee contributions and subject to similar limits as exist at present. A parallel scheme would be available for farmers and the self employed. Ideally, people in existing pension schemes would be free to transfer their investments to the new scheme or to opt out of the new system and maintain their present arrangements.

Pillar 3

Voluntary contributions from employees, employers, self-employed and farmers. We see this pillar as providing a mechanism to allow tax incentives or counterpart Exchequer contributions to be targeted on particular groups such as people whose existing pension entitlements or savings are inadequate, including parents who have taken time out of the workforce.

All contributions would be collected through the tax system.

How the scheme would work

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[17] By soft mandatory or auto-enrolment we mean that employee and employer contributions would be deemed to be made unless the employee and employer agreed to opt out. This concept is now being applied in New Zealand and in the UK. A parallel regime would apply to farmers and the self employed.

[18] Currently most occupational schemes are based on a 5% contribution from the employee and 10% from the employer. It is likely that these rates will need to be increased to ensure adequacy.

Access to the funds in **Pillar 1** would only be available to account holders from an legislatively prescribed pension age and only in the form of a Government determined income. This retains the essential characteristics of the PRSI Contributory Pension which would remain as an important basic income. However, a number of changes are required.

In our view

- For pension purposes a single contribution rate would apply to all contributors irrespective of employment status – whether employed or self employed. For employees the contribution (and rate) would be apportioned between the employer and the employee.
- The application of an income ceiling to the employee contribution would be a matter for debate. If there were no ceiling then the contribution would be redistributive (better off people would pay more) . In these circumstances the employee contribution could be merged with general income taxation and the employer contribution could be changed into a flat –rate payroll tax.
- the Exchequer contribution to the Social Insurance Fund should be raised to historical levels to reflect the original Beveridge vision of social solidarity.

A number of other changes not related to tax treatment should be made. These include

- The entitlement rules need to be changed to remove existing anomalies
- Any restrictions on people drawing their pensions if they continue to work after pension age should be removed.
- An option should be provided for people to defer their pension entitlement in return for a higher rate of pension actuarially determined.

The rationale behind **Pillar 2** is to increase pension provision by those with none at present and by those making inadequate provision under defined contribution schemes. Contributors to this problem are general inertia and the unwillingness of younger people to tie up money for periods of up to 40 years when they have other priorities and demands on their cash flow.

To deal with the inertia problem, we recommend a change to auto-enrollment. Contributions could be made to a defined contribution scheme provided by the employer or through the tax system to the National Savings Fund (NSF). Where an employer provides a defined contribution scheme, the employee must have contributions deducted unless they specially opt out in writing. Where an employer does not provide a pension scheme or the individual is self-employed, a default auto-enrollment mechanism is applied by the National Savings Fund. Contributions are collected through the tax system.

To provide greater encouragement for younger people to make pension contributions we consider that a proportion of pension savings could be withdrawn for certain limited life events without tax penalty. One such event should be to allow first-time buyers to use pension savings for house purchase.

The National Savings Fund which could be managed by NTMA should have the following features

- Individual accounts with regular information available to account holders on the status of the accounts
- Tax relief provided on the SSIA model
- Ability to withdraw funds without penalty for certain life events.

Account holders in **Pillars 2 and 3** would be free subject to actuarially based regulation to draw down their funds in part as capital payments and as income annuities from a prescribed age (say 55+). Earlier and partial withdrawals would be allowed (subject to limits) for a specified number of major life events – e.g. first house purchase and children's education. If an account holder were to die the funds in the account would form part of his or her estate.

Implications

1) The key psychological change is that each individual contributor is transformed from being a beneficiary with albeit entitlements and expectations to being an investor/account holder – with ready and continuing access to information about her or his savings.
2) Individuals would not be tied to the pension schemes established by their employers. Any technical difficulties surrounding portability and job change are dissolved. The scheme would promote labour mobility and economic efficiency.
3) The account transparency, investor ownership and soft mandatory character of the contributions to Pillar 2 represents a middle way between trade union objectives to protect the post employment income of their members through having mandatory contributions and employer concerns about increasing the tax wedge. The Pillar 2 contributions in essence becomes a form of "soft" compulsory saving.
4) The provision for early partial withdrawals regime is more relevant to the needs and time horizons of younger people than a "pure" pension scheme.
5) Account holders would be able to make decisions on the desired balance between employment and pension income. The scheme would have a role to play in encouraging people to continue in the labour force doing work of their own choice. There would be no mandatory barriers to continuing to work after "retirement age" but employers would retain the discretion to apply compulsory retirement ages for career positions.

Investment and fund management policies

The funds would be under the management of a statutory board (The National Savings Fund – NSF[19]). The funds in **Pillar 1** would be invested in secure income funds – mainly government paper. Investors would be free to advise the NSF of the risk desired profile they wish to apply to their funds in **Pillars 2 and 3** and to change these profiles over time and in line with their own requirements and market conditions. The NSF could competitively contract fund management to a portfolio of managers as well as managing funds directly.

Clearly a structural change of this magnitude would take some considerable time to fully implement and would encounter a range of implementation challenges. However, the potential benefits are very considerable. They also open up the possibility of new policy instruments for Government. For example, the Exchequer could make payments into **Pillar 3** for individual parents (almost exclusively mothers) who take time out of the work force to look after their children. The NSF would have considerable funds available for investment and subject to robust governance and rigorous appraisal, there could be opportunities for the NSF to loan funds for investments in essential productive infrastructure..

If a decision in principle is made to go in this direction, a road map is required. An early step would be to simplify and increase the transparency to individual contributors as to their entitlements under the PRSI system.

The Carbon Tax

The Programme for Government states that ***"appropriate fiscal instruments, including a carbon levy, will be phased in on a revenue-neutral basis over the lifetime of this Government."*** The Commission on Taxation's terms of reference require it to

"*Investigate fiscal measures to protect and enhance the environment including the introduction of a carbon tax".*

As the introduction of a carbon tax requires a completely new tax charge and structure, the Commission is asked to commence work in this area immediately."

Ireland is likely to face a daunting challenge in meeting its EU commitments to reduce emissions.

The January 2008 EU Commission proposals would require us to cut emissions in the domestic sector (agriculture, transport, small industry, construction and residential) by 20 per cent compared to 2005. At present agriculture accounts for 41 % and transport 29% of domestic sector emissions so it is difficult to see us meeting our obligations unless there is a major contribution from these sectors.

[19] Working title only. The NTMA/NPRF model could be developed to meet this mandate.

The transport sector poses a particular problem in that emissions have grown by over 160 per cent since 1990. The problem is that price increases seem to have little effect on the amount of driving we do, at least in the short term. In the last four years, the increase in the price of petrol is equivalent to a carbon tax of €120 per tonne and over that period, the amount of fuel used for private transport has grown by over 20 per cent.

However, a carbon tax is only part of the answer to reducing emissions. ESRI has estimated that a carbon tax of €20 per tonne would reduce emissions by 4.4 million tones. This compares with our need to reduce emissions by about 10 million tones by 2020.

Given all this the issues in relation to a carbon tax are

- What is the appropriate design of the carbon tax?
- When should it be introduced and at what level?
- How should the revenue be used?

A number of points should be made:

- Companies subject to the emissions trading regime should be exempt from any carbon tax.
- The tax should be introduced at a relatively low rate and increased over time to match the carbon price under the emissions trading scheme.

There are a number of options for recycling the yield from a carbon tax:

1. Use the money to compensate less well off households. Proponents of this option argue that expenditure on fuels as a proportion of income is higher for lower income groups (than for higher income ones) and that the fuels used by the lower income groups tend to have the highest carbon content (coal, peat) and would therefore attract the higher taxes.
2. Pursue a revenue-neutral policy and channel their carbon tax 'take' back to households and/or business affected by the tax.
3. Treat carbon tax revenue as simply another contribution to general government revenue and should be used to fund overall government expenditure.
4. Use the money for general tax reductions.

We need to carefully consider the impact of any carbon tax on competitiveness. Business is already experiencing significantly higher energy costs and the price of energy vis-a-vis that in other countries needs to be taken into account.

Tol et al (A Carbon Tax for Ireland, ESRI Working Paper no 246, June 2008) conclude that the revenue from a carbon tax would be best used to mitigate the distributional implications of the tax and reduce labour costs. They also find that a carbon tax would be mildly regressive and that a relatively modest increase in benefits would offset this

Given the adverse effects on Ireland's competitiveness, we believe that most of the revenue should be devoted to tax reductions and should be focused on improving competitiveness to the maximum possible extent. PRSI reductions may be the best option to improve competitiveness.

In relation to motor taxation, an important first step may be to shift taxes on cars from fixed to usage taxes as far as the cross-border situation allows. For example, according to the AA Roadwatch website, the price of unleaded petrol per litre in September 2008 in the North of Ireland was 12 per cent above that in the South. This would appear to offer scope to increase excise duty on fuel and reduce VRT.

The Adequacy of Tax Revenue

The Commission's terms of reference mandate it to recommend on providing the resources necessary to meet the cost of public services and other Government outlays in the medium and longer term.

The starting point for consideration of this issue is to come to a view on the adequacy of the existing level of tax revenue to fund public services. The analysis in Appendix 1 concludes that present structural factors result in Ireland having a relatively low tax burden without having to sacrifice the quality of important public services (assuming equal efficiency of Irish public administration).

A number of these structural factors will continue to be in our favour over the medium term. These are our relatively low defence spending and (hopefully) debt service costs together with our relative demographic advantage in the age structure of the population. While the tax burden may have to rise to meet the higher costs arising from an ageing population, Ireland should still be able to maintain a relatively competitive tax system.

Enhancing the democratic capacity to take needed but unpopular decisions

The consistency and resolve of Irish tax policy – corporate tax policy for half a century and personal tax policy since 1987 – has been one of the triumphs of Irish economic development. This has been underpinned by a widely shared political consensus and by social partnership.

Proposals for tax reform are potentially unpopular – this is certainly the case for the proposals we make for a recurring property tax. Similar reactions may apply to some or many of the proposals in the report of the Commission on Taxation. We are concerned that the nature of the public policy making space which includes easy media access by interest groups (and very often domination of media commentary by some of these groups), allied to the dynamics of an adversarial political system, make it impossible to carry out far reaching and desirable structural reform especially where powerful interest groups perceive the reforms as adversely affecting their interests. [20]

Perhaps we can learn from social partnership?

Social partnership has contributed enormously to economic and social development. It has shown over a twenty year period that Government, trade unions, employer organisations and other social partners have been able to pursue agreed aims without sacrificing their fundamental objectives while continuing to disagree on many issues.

Notwithstanding its strength, social partnership does have shortcomings - including an imperfect interface with the parliamentary system.

Do Government and Opposition perhaps now need to turn their attention to devising mechanisms which would facilitate agreement around important directions for policy without encroaching on the duty and accountability of Government to govern and that of Opposition Parties to subject the Government to vigorous scrutiny and opposition? Could there be opportunities within the existing arrangements in the Oireachtas for making progress? Could a structured attempt be made, for example, to try to agree on agreed broad objectives of policy in crucially important areas such as taxation and climate change? Parliamentary committees together with the establishment of widely based multi-lateral consultation mechanisms such as the Forum of Europe, the New Ireland Forum and the National Education Convention could perhaps have a role in forging consensus positions. Should the report of the Commission on Taxation be followed by the establishment of an Oireachtas Forum on Taxation?

[20] There is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things" The Prince, Niccolo Machiavelli.

Appendix 1

The Tax Burden: Is It High Enough?

Some argue that the Irish tax burden is too low and that an increase in taxes is now necessary if we are to enjoy first class public services. We now examine the evidence.

The latest OECD figures relate to 2006. These show that taxation in Ireland as a percentage of GDP is 31.7 per cent compared to an OECD average of 36.2 per cent. The EU 15 average is 39.8 per cent.

The costs of providing public services are more related to GNP in Ireland. However, due to the importance of the multi-national sector, GNP is about 85 per cent of GDP. The tax/GNP ratio in Ireland in 2006 was 37.1 per cent

Services

Does this imply that our public services must be worse than other EU countries? Before we can answer this question, there are a number of special factors that must be taken into account. These include:

- Differences in debt service costs
- Differences in defence spending
- Capital spending requirements
- Differences in the way pensions are funded
- Demographic differences
- Payments to the National Pensions Reserve Fund

Debt Service Costs

The reduction in our national debt to well below half the EU average has cut the amount of tax revenue needed to service debt by 8.7 per cent of GNP over the last 20 years. That makes a lot more available to fund public services.

Debt service in Ireland now takes about 1.6 per cent of GNP compared to an EU average of 2.9 per cent.

Defence Spending

Defence spending in Ireland is among the lowest in the EU. In 2007, we spent about 0.6 per cent of GNP compared to an average of 1.6 per cent of GDP for EU countries in NATO. This means that, other things being equal, our spending should be 1.0 per cent of GNP less.

Pensions

In most EU countries, the bulk of the expenditure for old age and survivor benefits comes out of statutory pension schemes and is financed out of social insurance contributions and general taxation. Ireland is significantly different in that most pensions are financed on a pay-as-you-go basis in the public sector or through funded private schemes. Eurostat [21] has estimated that old age and survivors benefits on average took 12.2 per cent of GDP in 2005 in the EU 15 compared to 4.5 per cent in Ireland (GNP 5.25 per cent).

This factor accounts for a significant difference in observed tax ratios.

Demography

Old age dependency in Ireland (Ratio of population over 65 to the population aged 20-64) is estimated at 16.3 per cent – the lowest in the EU. The EU average is 25.5 with Germany and Italy having a ratio of just over 30 per cent.

A Fraser Institute study of health spending in Canada [22] notes that those aged 65 years and over consume more than three times the average spending for all age groups while those over 85 consume more than seven times the average. Their estimate is that in 2007 Ireland's favourable demographic structure was worth about 2.1 per cent of GNP.

While one would expect the need for education spending and child related welfare spending to be somewhat higher than in other EU countries, this is unlikely to match the large saving on health and pensions spending. It is clear that our favourable demographic structure implies a lower need for public spending to provide an equivalent level of public services.

Capital Expenditure

Ireland's infrastructure is clearly deficient, which means that we have to spend a greater proportion of our resources on investment than countries with more developed infrastructure. Ireland is spending about 5 per cent of GNP on public investment compared to an EU average of about 3 per cent.

National Pensions Reserve Fund

Ireland is allocating 1 per cent of GNP to provide for social welfare and public sector pensions in future years. This is not contributing to the volume of public services now. Hence, we have deducted this in computing the adjusted tax ratio for Ireland.

[21] Social Protection in the European Union, Statistics in Focus, Eurostat, 46/2008, May, 2008

[22] How Good is Canadian Healthcare? 2007 Report. Nadeem Esmail and Michael Walker, Fraser Institute, Cananda, November, 2007

Conclusion

The effect of these adjustments is summarised below

Ireland Tax/GNP Ratio 2006		37.1	
Add			
Debt Service	1.3		
Lower Health Spending	2.1		
Defence	1.0		
Pensions	6.9		
Total	11.3	11.3	
Deduct			
Irish Budget Surplus		2.9	
Capital Spending		2.0	
NPRF		1.0	
Total		5.9	5.9
Irish Adjusted Tax Ratio			42.5
EU Average			39.8

All this supports the view that structural factors result in Ireland having a relatively low tax burden without having to sacrifice the quality of important public services (assuming equal efficiency of Irish public administration).

When one adjusts for these factors, the tax burden in Ireland should deliver public services worth 42.4 per cent of GNP which is better than the EU average of 39.8 per cent. We will not always have this advantage. This suggests that whatever may be wrong with the standard of public services we have, it is not due to a lack of taxation.

Appendix 2 – The Authors

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Dr Don Thornhill

A former top civil servant (Secretary General of the Department of Education and Science and later Chairman of the Higher Education Authority), Dr. Don Thornhill is now a consultant and adviser on strategy and policy. He is also a board member of a number of organisations in the public and private sectors – including Science Foundation Ireland, the Irish Taxation Institute and Forfás.

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