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ECONOMIC GROWTH AND EQUITY IN TAX POLICY

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Economic Growth and Equity in Tax Policy

This paper has been prepared as a contribution to the discussion in the breakout session at the National Economic Dialogue. It should not be seen as prescriptive but rather seeks to set out the current factual situation and to suggest some of the key questions which participants may wish to consider.

Key Guiding Questions:

- ***Can we further reform the tax system to promote both sustainable growth and a fair society?***
- ***What can or should be done to address the fact that, while highly progressive by international standards, our tax system also features high marginal tax rates on relatively modest incomes?***
- ***Should the tax system play a greater role in tacking environmental threats and promoting sustainable development?***

BACKGROUND

Purpose and economic effects of taxation

The primary function of the tax system is to finance public expenditure while, in combination, taxation and public spending contribute to public policy objectives such as economic growth, equity and sustainable development. Taxes influence economic activity through their effects on decisions by households and firms on investment, savings, labour market participation and employment. These decisions are affected not only by the level of taxes but also by how taxes are designed and combined to generate revenues.

The OECD has produced a hierarchy that ranks taxes on the basis of impacts on economic growth. It suggests that corporate income taxes are the most growth-harmful type of tax, followed by personal income taxes and then consumption taxes, with recurrent taxes on immovable property the least harmful.

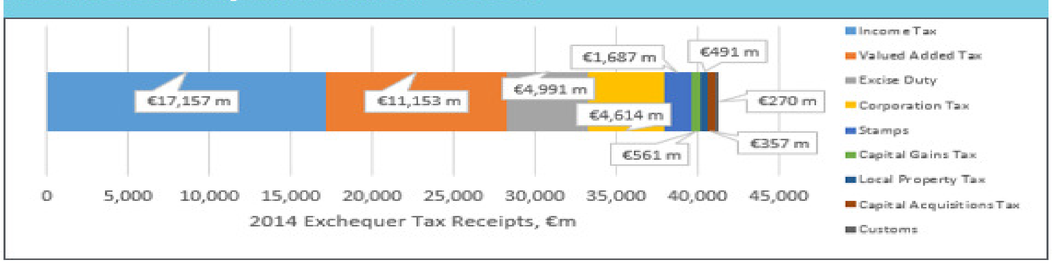
Ireland's tax burden and its distribution

Measured as a proportion of Gross Domestic Product (GDP), Ireland has a relatively low tax burden by European standards according to the latest data. In 2012 total taxes were 28.7% of GDP compared to the EU-28 average of 36.3%. However, given the exceptional gap between GDP and Gross National Product (GNP) in Ireland, the Irish Fiscal Advisory Council (IFAC) have argued that a more appropriate measure of fiscal capacity is a hybrid measure taking GNP plus 40 per cent of the gap between GDP and GNP. On this basis, the tax take share rises to 32.4%.

If social security contributions (SSC) are excluded from the comparison (given the stronger insurance character of these systems in other EU countries compared with Ireland), the tax take at 24.3% of GDP is marginally below the EU-28 average of 25.2%. As a percentage of the IFAC measure this rises above the EU average to 27.5%.

Of total tax receipts in 2014 of €41 billion, income tax (including Universal Social Charge) comprised 42%, VAT and Excise 39%, Corporation Tax 11%, Stamps 4% with the remaining tax heads making up approximately 1% each.

FIGURE 1: EXCHEQUER TAX RECEIPTS 2014



Equity

Two distinct concepts of equity of relevance to taxation are horizontal equity and vertical equity. Horizontal equity implies that the tax system should afford similar treatment to similar people while vertical equity indicates that those with a greater ability to pay should pay more. Vertical equity is consistent with progressive taxation. In Ireland, the reduction in the Gini coefficient (a measure of income inequality) between market incomes (i.e., before taxes and transfers) and disposable incomes is greater than in any other OECD country reflecting the progressive nature of the income tax system and the effect of transfers.

One example of the trade-offs that arise between horizontal equity and efficiency considerations is that, from the former perspective, it might be argued that all types of income should be taxed similarly. On the other hand, an efficiency perspective would suggest differential tax treatment on the basis of the OECD hierarchy.

Other Principles

As well as equity and efficiency, other important principles in tax system design include neutrality (meaning that the tax system should not affect taxpayer behaviour so that decisions are based on preferences before tax considerations); stability; and flexibility (the tax system should be responsive to changed economic circumstances). More generally, the Commissions on Taxation (2009 and 1984) took the view that maintaining a focus on a well-designed tax policy system has a much greater capacity to achieve economic and social goals than could be promoted through individual tax incentives. In addition, the OECD and other observers have argued that a "broad base, low rates" approach is conducive to an efficient tax system.

INCOME TAX

Ireland's income tax system is highly progressive with those on higher incomes paying proportionately higher tax rates. For example, the ratio of the tax burden for those earning 167% of the average wage to those earning 67% of the average wage at 1.8 is the 2nd highest in the OECD, with the OECD average at 1.25. However, this progressivity entails high marginal tax rates which affects labour force participation and individual decisions on how much to work. According to the latest data, Ireland has the 10th highest marginal income tax rate of the 34 OECD members but it takes effect at a relatively low income. Changes in Budget 2015 mean that the PAYE 52% top marginal rate applies at incomes of just above €70,000 but a rate of 51% applies at an income of €33,800 for a single individual i.e., just below the average wage. By way of comparison, the UK marginal tax rate of 47% in 2014 applied at stg£150,000, while Spain's marginal tax rate of 52% applies at €300,000, approximately 4.2 and 11.7 times the respective average wages.

CORPORATION TAX

Ireland's corporation tax policy has been designed to attract foreign direct investment (FDI) and encourage domestic enterprise to support employment and growth.

In 2014, the Department of Finance undertook research which concluded that:

- An increase in Ireland's corporation tax rate would reduce inward FDI flows.
- The effective rate of corporation tax is close to the headline rate of 12.5%.
- Corporation tax revenue in Ireland is broadly in line with the EU average, both as a share of the total tax base and as a percentage of GDP.
- There is a high level of concentration in corporation tax revenue in Ireland, relying on a relatively small cohort of large taxpayers.

ENVIRONMENTAL TAXATION

The rationale for environmental taxation is to ensure that the costs pollution imposes on society are borne by the polluter. Over recent years Ireland has introduced and reformed a number of environmental taxes with this in mind including:

- a Carbon Tax on fossil fuels which aims to address environmental concerns;
- reform of Vehicle Registration Tax (VRT) and the motor tax charging system for new private cars to align the system with environmental policy objectives whereby cars are taxed based on CO2 emissions levels;
- renewal of Accelerated Capital Allowances for Energy Efficient Equipment allowing companies to immediately deduct 100% of expenditure incurred on eligible equipment;
- operation of the Employment and Investment Incentive scheme (EII) incentivising investment in renewable energy generation; and
- provision for Natural Gas and BioGas as a transport fuel at the minimum EU rate of excise.

The European Commission has highlighted the reduced VAT rates on energy products in the context of environmental taxes and subsidies. Such reduced rates are common across OECD countries reflecting concerns of policy makers that households spend a relatively large share of their income on energy. This highlights one of the trade-offs as between equity and environmental considerations.

CAPITAL TAXATION

Developments in capital taxation in recent years has been characterised by the need to protect yields during the economic and fiscal crisis. The rates of Capital Gains Tax (CGT) and Capital

Acquisitions Tax (CAT) have risen to 33%, with CAT thresholds decreasing during a time of falling asset values. On the other hand, specific targeted CGT measures have been put in place to encourage entrepreneurial activity. Taxes on savings, via DIRT and exit taxes, have increased; the objectives being both protection of yield and the encouragement of economic activity. DIRT is now applicable at 41%. Over the same period, the rate of stamp duty as it applies to property has decreased considerably during the transition from transaction based taxes to the annual recurrent Local Property Tax in line with the OECD hierarchy of taxation harmful to economic growth.

FURTHER GUIDING QUESTIONS

Overall

- In light of the anticipated fiscal space of €1.2–€1.5 billion to be split 50:50 between tax reductions and expenditure increases, what would be the best use of the circa €600 - €750 million available for use on the tax side?
- Is it time to revisit previously controversial tax issues such as standardising VAT at one rate for all goods and services, individualisation of income tax, wealth and inheritance taxes and refundable tax credits?
- What can be done to direct the tax system away from tax incentives and special pleading towards improving the overall taxation framework?
- In what direction should the composition of taxation be shifting towards?
- How can reductions in the tax burden be managed without excessively narrowing the tax base?

Income Tax

- In a highly competitive international market for highly skilled mobile individuals, is the highly progressive nature of the Irish income tax system a barrier to sustainable growth?
- Are the high levels of progressivity of the Irish income tax system truly equitable? Is it right that the top 1% of income earners pay 20% of the total income tax and USC collected while almost 30% are exempt entirely?
- Should the tax system continue to be used to provide social 'goods' in the form of additional credits and reliefs for certain groups or would it be more equitable to provide such 'goods' via expenditure measures?

Corporate Taxation

- How can our tax regime better encourage entrepreneurship and innovation?
- What role should Ireland play in international efforts/drives to reduce aggressive international tax planning (like OECD BEPS)?
- How can Ireland continue to maintain a successful corporate tax policy that attracts and sustains foreign direct investment, but which also ensures the maximum benefits

Environmental Tax

- What more can be done on environmental taxes and how can lower income households (not necessarily in receipt of social benefits) be protected from the impact of such measures?

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