Chapter 14 Income Taxation in Ireland

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The Commission on Taxation published five reports between 1982 and 1986. The Irish income tax system had developed in a piecemeal, ad hoc manner and the Commission's review of its operation helps us to assess the tax system on the principles of simplicity, equity and efficiency and to identify policy changes which would lay the foundations for a more coherent system. The 1989 Budget, then, is to be judged according to the recommendations set out in the Commission's report.

Income taxation is a highly controversial issue in Ireland. Despite its claim to be based on 'ability to pay', and to be redistributory through progressive marginal rates of tax, the system is perceived to be highly unfair and inefficient. Income taxation is used both as a source of revenue for government expenditure plans and to further social policy objectives through the allocation, distribution and stabilisation effects of taxation.

A number of principles underlie the Commission's recommendations. Firstly, there should be a comprehensive definition of income to include currently excluded sources such as welfare benefits, capital gains and gambling winnings. This is a widely-held objective, being seen as simple and equitable because it does not discriminate between income sources. Admittedly, administration problems arise such as the annual valuation of capital assets to assess accruing capital gains and the possibility of large cash bills to holders of illiquid assets such as housing. It is undeniable, however, that the existence of different tax schedules for the P.A.Y.E. and self-employed and the many reliefs, exemptions and exclusions in the existing tax code (left unchanged in the budget) fall a long way short of a comprehensive definition of income.

Equal taxation of different income sources is a related issue. At present, it is possible to avoid tax by converting investment income into capital gains (via institutionalized savings forms, such as pension funds), or by seeking remuneration in the form of fringe benefits or stock options. This is because capital gains are excluded from the income tax code (unlike in the United States) and are taxed more lightly. Similarly, expenditure on 'relieved' items such as mortgage interest, life assurance and V.H.I. premiums, is allowable against tax. Such unequal treatment, also illustrated by more generous business expenses treatment for the self-employed, is inequitable in a horizontal sense, as people with similar incomes end up paying different amounts of tax, and in a vertical sense, as people on higher marginal rates are most likely to be able to minimize taxable income by expenditure on relieved goods. A tax net with such 'holes' in it is also inefficient as people are encouraged to allocate resources to tax-allowable goods. The savings market is particularly affected, with an incentive for investors to favour options which offer low dividends but high capital gains (such as pension funds). Kay and King call these "civil servants" assets rather than entrepreneurs' assets, and so the dynamism necessary in a thriving capitalist economy is discouraged by the income tax system. The reduction in tax allowances, from 50% to 40% of a life

assurance premium's value, and in the amount of mortgage interest relief introduced in the 1989 budget, was intended more out of a desperation for increasing revenue than an acknowledgement of the demerits of a highly selective tax system.

Part of the explanation for the complex system of allowance, exemptions, reliefs and exclusions is that the State views the tax code as an instrument of social policy. It seeks to positively discriminate in favour of targeted groups in its tax treatment. Thus, unmarried mothers, homeowners, social welfare recipients, company car drivers etc. all receive special treatment. Two flaws exist with this approach. Firstly, such a complex system requires an expensive administration machine to operate it. Secondly, only those with sufficient income to be liable for tax can benefit from the system, and this inequity is exacerbated by the fact the most reliefs are valued at the marginal tax rate (favouring high income earners) rather than being refundable tax credits which are of equal value to all. The Commission favours direct transfer payments to "targeted" groups rather than use of the tax code, as only those in need would receive such benefits and the neutrality of the tax code would be ensured. A neoclassical analysis of the tax system would object strongly to its selective nature as economic choices are distorted and, if individuals are assumed to be the best judges of their own welfare, this inevitably reduces economic welfare.

The present system's arbitrary nature is seen in other ways also. P.R.S.I. has no actuarial basis with no relationship between premiums and entitlements. As such, it should be regarded as a tax on income rather than as a 'social insurance contribution'. Some taxes - the health levy and the youth levy, for example - are earmarked for specific purposes which also offends simplicity, with no reason to believe that taxpayers are more ready to contribute if taxes are tied to specific uses. Different schedules for P.A.Y.E. and the self-employed similarly introduces complications, as well as giving credence to the popular belief that the non-P.A.Y.E. sector is lightly taxed. The 1989 Budget failed to remove these anomalies.

The combined effect of the above factors is to create a very narrow income tax base with many incentives to reduce one's tax liability by using the reliefs and exemptions mentioned above. Selectivity also creates a complex system and distorts economic choices. The impact of the Commission's recommendations to simplify the system and to widen the tax base would be to remove these problems. In particular, a wider tax base would enable marginal rates of tax to fall while still attaining the same level of revenue. High marginal rates, then, are a symptom, rather than the cause, of the weaknesses in the present system.

The 1989 Budget saw the lowest rate fall from 35% to 32%, the middle rate to remain at 48% and the top rate to fall from 58% to 56%. The exemption level of income, below which no tax is paid, was also raised. High marginal tax rates are seen to have a serious impact on work patterns and behaviour. While substitution and income effects appear to cancel out for primary earners, high marginal rates do encourage tax avoidance measures such as seeking remuneration in stock options rather than cash. Also, a high marginal tax rate creates a preference for leisure rather than work, a preference which is very strong for secondary earners such as married women or the retired who are not so committed to fixed career paths. Emigration by the young and the innovative is also encouraged. However, perhaps the two most serious consequences of high marginal rates are their consequences for the poverty trap and the black economy. Marginal rates are commonly believed to rise uniformly with income levels but in fact follow a U-

shaped trend. At very low levels of income, the benefit of earning a wage is offset by losing welfare entitlements so that the effective marginal rate of tax may exceed 100% - a very strong disincentive for the unemployed to accept employment. This illustrates the need to regard the taxation and social welfare systems in unison. The 1989 Budget did seek to neutralize the poverty trap by reducing the bottom rate to 32% and by raising the exemption level. However, social welfare benefits were also increased, so the net effect was merely to shift the area of the poverty trap up the income scale rather than to remove it. For disincentives to be minimized, welfare benefits should be taxed so that the low income person faces a gradual rise in his/her marginal tax rate rather than abrupt cut-off points as illustrated above. The black economy is also encouraged, as those in service industries prefer to do 'nixers' rather than see 56% of their income disappear in tax (1).

It is clear, therefore, that substantial tax reform is necessary. This does not mean a reduction in revenue levels, which is undesirable given the current fiscal situation if lower marginal rates are achieved through a widening of the tax base. The major flaw in the 1989 Budget, then, was that this relationship between the width of the tax base and marginal rates of tax was barely recognized. Scarcely any move was made to end the various allowances, reliefs, exemptions and exclusions which underpin the present narrow base. The explanation for this is largely political - it was said once that "hell hath no fury like the middle-class in danger of losing their subsidies" (2). Thus, while everyone is in favour of tax reform, few are willing to give up their own particular tax benefits. The Commission's own recommendation is curiously flawed. While advocating a single rate of income tax levied on a very wide base, it recommends that any desired progressivity should be achieved by a direct expenditure tax on high income earners. It seems unnecessary and inefficient to have such a dual system of direct taxation, combining an income base which depends on receipts, and an expenditure base which depends on payment.

Its final conclusion notwithstanding, the Commission's report must be regarded as the framework for reform of the income tax system. The 1989 Budget has been described as a "hiatus" budget and the above comments show that little has been done to implement the Commission's recommendations.

Footnotes

1. The black economy may also be tackled by stricter policing which is promised under the Amnesty. This tackles, however, the consequences and not the cause of the black economy's existence.
2. The child benefit controversy illustrates the skill of the middle classes to protect even indefensible benefits.