Irish Tax Policy Issues

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The recent economic crisis made clear some major short-comings in the Irish tax system.

Over the last decade, during the boom years for the Irish economy, the tax system became increasingly dependent on revenue from property related activity. This was politically expedient as much of this tax was funded by borrowing more money (to pay the tax) and it often did not impact on consumption levels. However, with a collapse in the property market bubble this revenue dried up. At the same time expenditure ballooned on items such as unemployment benefit payments. The result was that having had a government surplus, it turned into a huge deficit by 2009 (Figure 1).

To deal with this crisis there has been a dramatic reduction in expenditure – accounting for a major part of the essential fiscal adjustment, However, one third of the adjustment has involved changes in the tax system to bring in more revenue.

The Irish tax system involves quite a low share of revenue coming from social insurance payments and quite a high share coming from taxation on companies (Figure 2). The structure of revenue is not very different from that in Sweden but the overall share of GDP/GNP accounted for by government revenue is much lower in Ireland.

There have been two Commissions on Taxation, one in the early 1980s and a second that reported in 2009 on how the tax system should be reformed to best meet the needs of the Irish economy. They both recommended widening the tax base as far as possible and using the widening of the base to reduce marginal rate. They also recommended reducing transactions taxes on property and introducing a property tax as part of the base widening.

The strategy on corporation tax was first developed in the mid-1950s with the introduction of a zero rate for profits earned on exports. With EU membership, this distortionary approach had to be modified, first in the 1970s by a common 10% rate for firms in the industrial sector and then in the late 1990s by the introduction of a common 12.5% rate covering all economic activity. This low rate is accompanied by a wide base – there are limited write offs available for firms to further reduce revenue.

The low corporate tax regime has seen a major influx of foreign investment, especially in manufacturing. Approximately half of the employment in that sector is in foreign owned firms. The low rate, combined with the consistency of the approach adopted over half a century, has proved reassuring to foreign investors.

The extension to the services sector of the low rate resulted in some lost revenue from firms in that sector but the additional activity generated more than replaced the revenue and it is estimated that the change resulted in a once off increase in the level of GNP of around 3.7% (Conefrey and FitzGerald, 2011). If the rate were to change suddenly upwards there would be likely to be a major loss of employment and activity in both the services and the manufacturing much more than reversing the gains from the reforms of the late 1990s.

However, dependence on the low corporation tax regime as the major instrument of industrial policy is a strategic risk for Ireland. Tax rates are falling elsewhere – e.g. UK rate of 20% - reducing the comparative advantage. Also there are pressures from outside to change the regime in different ways. A sudden change would be very costly. However, a long-term objective should be to wean the Irish economy off its dependence on the regime over the next 15 years by refocusing industrial policy to concentrate on Irish-owned firms.

Also action to close down some of the more glaring anomalies whereby some US firms pay no tax anywhere on their profits is important for reputational reasons. However, because this behaviour hinges on key provisions of the US tax code, any action by the Irish authorities is unlikely to result in higher revenue in Ireland or elsewhere in the EU. The 2014 Budget took some measures to tackle this problem and it remains to be seen how effective this is. The objectives is to protect the low tax corporation regime applying to firms undertaking major production (and employment) in Ireland.

As a result of the crisis a significant property tax has been introduced. While previous such attempts generally ended in political failure it seems likely that this reform will survive into the future. This has the effect of broadening the tax base in a way that does not impact on the incentive to work. The alternative would have been to increase income tax further which would have had more negative employment effects.

A carbon tax has also been introduced. This is seen as the most economically efficient way to reduce greenhouse gas emissions. However, the current EU ETS scheme is a relative failure with negative distributional affects. Even if it proved an effective instrument in the future it could have unexpected and perverse distributional effects. An EU-wide carbon tax (or a carbon price floor as in the UK) would be a much more effective instrument for reducing greenhouse gas emissions across the EU.

The effects of a Financial Transactions Tax on the Irish economy was studied in Central Bank of Ireland and FitzGerald, 2012. This report found that the proposed FTT would bring in some additional revenue but the net revenue gain would be limited as the existing domestic FTT (Stamp duty) would have to be abolished. Also the FTT as proposed could have significant negative effects on the costs of some financial services – hedging exchange risk, liquidity etc. There could also be a movement abroad of significant financial services. Nonetheless, I would conclude that if there were wider gains from adopting an FTT it might be a pawn that Ireland could sacrifice. Also, if a more economically coherent FTT were proposed, that might deal with the relative under-taxation of financial services, this could be more attractive.

The experience of the 1980s was that high rates of personal taxation (e.g. 80%) had major deadweight losses. As a result, the tax system was reformed to broaden the base and reduce marginal rates. However, in the boom years the system was hollowed out so that many individuals today are not liable to pay any income tax. In raising revenue to meet the state's funding needs marginal rates have again crept up to over 50%. A further effort to widen the base and reduce marginal rates could see pay-offs in terms of higher employment.

Nobody in Ireland has escaped pain in the current crisis, but some have suffered more than others. In particular, those who lost their jobs have been severely affected and their problems have been even greater where they have mortgages. While public policy has played a role in modifying the

impact of the crisis on households, the main effects have come from the changes in the economy itself. The dramatic increase in unemployment has significantly increased the numbers of families at risk of poverty and it has also contributed to the rise in the "consistent poverty rate".

When considering the impact of the crisis on the distribution of income, account must also be taken of the decline in real incomes of many of those working, including those working in the public sector. There has also been a big impact on the incomes of a significant number of really high earners. Many of them were dependent on the property bubble for their livelihoods and the bursting of the bubble has seen a dramatic decline in their fortunes. Between 2007 and 2010 the numbers earning over 100k fell by almost 15 per cent and, in addition, the average income of those who were still earning over 100k fell by around 8 per cent.

While the underlying driver of change in the distribution of income (and in the numbers at risk of poverty) has been the changes in economic fortunes, public policy has also played an important role in modifying their impact on households. Callan et al., 2013, show that the effects of changes in the tax system and the welfare system over the period 2009-2014 have reduced the incomes of the richest 10% of the population by 15.5%. For the poorest 10% the decline in income as a direct result of public policy was 12.5%, whereas for the rest of the population the decline was between 11% and 12%.

However, while changes in public policy did not have a major impact on the distribution of income, the operation of the existing welfare system, interacting with the wider changes in the economy, shielded an increasing number of people from the risk of falling into poverty. While the "at risk of poverty" rate in 2011 was 16%, CSO data indicate that, without welfare transfers, it would have been close to 50%. By contrast, in the boom years it would have been under 30% without transfers. The resulting increase in welfare payments has contributed to the problems in the public finances.

The latest data for Ireland (for 2011) suggest that the distribution of income in 2011 was rather similar to what it was in 2007 and 2008. For 2009, the first full year of the crisis, the distribution of income, as measured in this way, was the most equal that it has been since the 1980s. Callan et al.¸ conclude that the overall changes in the distribution of income over the crisis years mask substantial losses for the poorest and the richest 10 per cent of the population. In the case of the richest 10% of the population a significant contributor to the loss has been the increase in taxation.