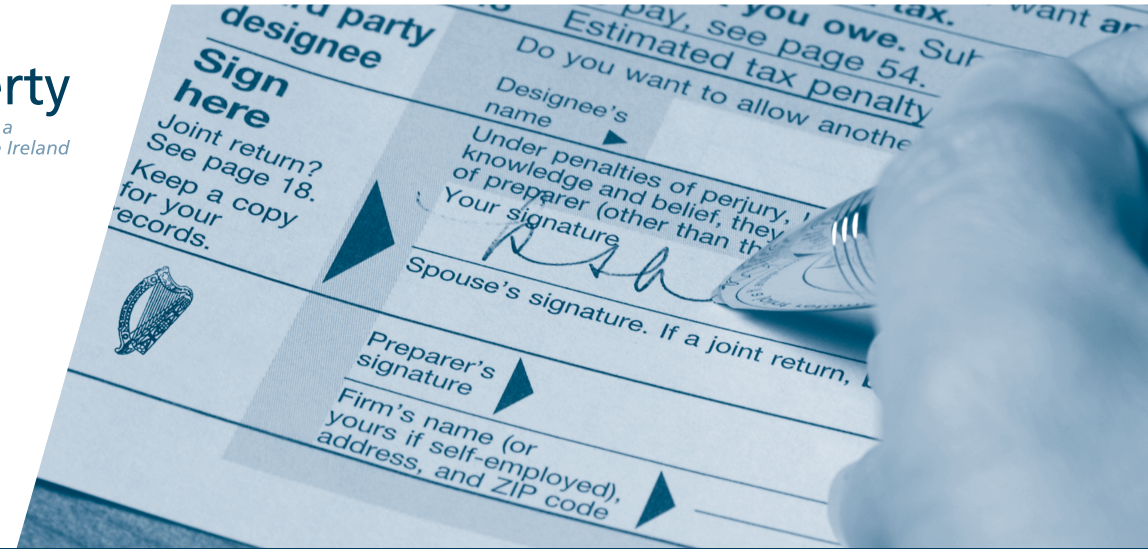
POLICY STATEMENT

PROMOTING EQUITY IN IRELAND'S TAX SYSTEM

2006

Combat Poverty Agency
working for a poverty-free Ireland



1. Introduction

Combat Poverty is a state advisory agency developing and promoting evidence-based proposals and measures to combat poverty in Ireland. Combat Poverty works for a poverty-free Ireland by striving for change which will promote a fairer and more just, equitable and inclusive society.

In particular, Combat Poverty works towards a reduction in poverty levels by promoting the re-distribution of income and resources in favour of those living in poverty through reform of the taxation and social welfare systems, and by working to ensure that everyone has at least a minimally adequate income.

Taxation is one of the main means to redistribute wealth in society. Ireland has seen dramatic change in its tax regime over the past decade, with an emerging new paradigm of low (direct) taxes on work but with an increasing tax take on consumption (i.e. indirect taxes). The poverty implications of this paradigm shift have not been explored in any depth, heretofore.

To inform public policy on tax reform, Combat Poverty commissioned Farrell-Grant-Sparks to identify reform options from a poverty perspective by means of a review of the redistributive nature of the Irish tax system, paying particular attention to indirect taxation. This was because there is a considerable literature in Ireland on equity and direct taxation but far less work on the equity or distributional impacts of indirect taxation. The study also considered how the tax base can be widened in a more equitable manner and proposes ways to improve the redistributive nature of the tax system as a whole[1].

The study adds to the current literature on Irish taxation policy by addressing the issue of indirect taxation. The research methodology includes, inter alia:

- A review of national and international literature;
- An empirical analysis (i.e. simulation work) employing the most recent (2000) CSO Household Budget Survey of the distributional outlay on VAT and excise duty ; and
- Policy analysis of the key findings.

This Policy Statement summarises some of the key findings of that research, but places them in the current Irish policy context and advocates some proposed policy responses in key areas of tax expenditures, direct taxation, indirect taxation and corporation taxation. In 2005 Combat Poverty prepared a submission to the Department of Finance on its Review of Tax Reliefs and Exemptions for High Earners. The submission set out Combat Poverty's perspective on tax expenditures and briefly outlined the arguments for closing many of these down in an effort to broaden the tax base. The key recommendations of that submission are also covered in this document.

II. Policy Context

The taxation system is one of the main mechanisms to ensure a more equal society. Ireland has historically had a relatively high level of income inequality. To illustrate, using 2000 data, a low-income Irish person at the 10th (lowest) income percentile had an income that is just 41% of median income, whereas a high-income resident in the 90th (highest) income percentile had an income that is 189% of the median. In contrast, the income of the poorest decile in most other countries in the OECD averages 50% of the income of middle-income persons. This income gap between the rich and poor is sometimes called the Decile Ratio measure, and it equals 4.57 in Ireland (i.e. a person in the 90th percentile earns 4.57 times that of a person in the 10th percentile)[2].

1 See: Barrett, A. and Walls, C. (2006). *The Distributional Impacts of Ireland's Indirect Tax System,* Combat Poverty Agency/Institute of Public Administration: Dublin
2 Nolan, B. and Smeeding, T. (2004). *Ireland's Income Distribution in a Comparative Perspective.* Paper Presented at the 28th General Conference of the International Association for Research on Income and Wealth, 22nd-28th August 2004, Cork

During the Celtic Tiger years, many people were taken out of the tax net, through improved employment opportunities and progressive tax policy on incomes. Despite this, the latest Gini coefficient[3] from the EU Survey on Income and Living Conditions for Ireland is 0.318 (2004 data)[4]. Eurostat data demonstrate that income inequality has been hovering around this level since 1987, when the level was 0.328. Relative income poverty has remained stubbornly high, with 19.4% of Irish households falling below the 60% median income threshold in 2004[5]. The level of income inequality is likely to be due to a number of factors. First, social welfare increases have not kept pace with considerable wage growth over the past decade[6]. Second, very significant and dramatic economic growth has resulted in a large increase in high-paid jobs stretching the upper tail of the income distribution higher[7]. Third, successive income tax cuts have benefited high-income individuals more (in real terms) than those on low-incomes over the past decade[8]. Thus, the taxation system in Ireland needs to work better at redistributing resources.

As can be seen from the graphical representation below (Figure 1), the taxation system in most countries is comprised of three major components: direct taxes on labour (i.e. income taxes); indirect taxes on consumption of goods and services (mainly VAT and excise); and taxes on company profits (known as 'corporation tax' in Ireland).

Figure 1
The Three Main Elements of the Tax System in Ireland

3 The Gini coefficient is one of the commonly used measures of income inequality across the EU. Note that 0=equality and 1=inequality.
4 CSO (2005). *EU Survey on Income and Living Conditions (EU-SILC) 2004 (with Revised 2003 Estimates),* CSO: Cork.
5 Op cit.
6 Whelan, C.T., Layte, R., Maitre, B., Gannon, B., Nolan, B., Watson, D. and Williams, J. (2003). *Monitoring Poverty Trends in Ireland: Results from the 2001 Living in Ireland Survey,* Economic and Social Research Institute: Dublin
7 Clinch, J.P., Convery, F.J. and Walsh, B.M. (2003). *After the Celtic Tiger,* O'Brien: Dublin
8 Combat Poverty Agency (2005). *Ending Child Poverty* Policy Statement, Combat Poverty Agency: Dublin

Data presented in a new Combat Poverty study on taxation indicate that direct tax on incomes as a share of the total tax take has fallen dramatically in Ireland, from 35.1% of total revenue in 1995 to 29.5% in 2005[9]. However the proportion of the tax take accruing to VAT receipts has increased from 25.3% to 31% over the same period. Thus, it is fair to say that there has been something of a paradigm shift with regard to the taxation system in Ireland over the past decade, in which there has been a move away from direct taxes towards indirect taxation. This means that indirect taxes are now the most dominant and important stream of revenue for the Irish Exchequer. 2005 was the first time, historically, that receipts for VAT alone have exceeded those for direct taxes in Ireland. Table 1 presents revenues by category for 2003 and 2004 in Ireland. As can be seen from the Table, VAT, excise duty, income tax and corporation tax make up €33.6 billion, or 89.5% of total tax receipts in 2005. Total indirect taxes (VAT and excise duty) in 2005, at €16.7 billion, exceeded direct tax, at €11.1 billion, by 50%. Figure 2 illustrates that, of the 90% of total tax revenue made up by the top four categories (income tax, VAT, excise and corporation taxes). Just 17% of this revenue is collected through corporation taxation.

Table 1: Tax Revenues by Category in Ireland, 2003 to 2005[10]

	2003 (€000)	2004 (€000)	2005 (€000)
Income Tax	9,199,000	10,300,000	11,105,000
Value-Added Tax	9,611,000	10,244,000	11.625,000
Corporation Tax	5,015,000	5,350,000	5,760,000
Excise	4,573,000	4,600,000	5,075,000
Stamp Duties	1,646,000	1,600,000	2,085,000
Capital Gains Tax	1,350,000	851,000	1,500,000
Capital Acquisitions Tax	209,000	149,000	180,000
Customs	135,000	137,000	170,000
Agricultural Levies	5,000	5,000	5,000
Total	**31,743,000**	**33,236,000**	**37,505,000**

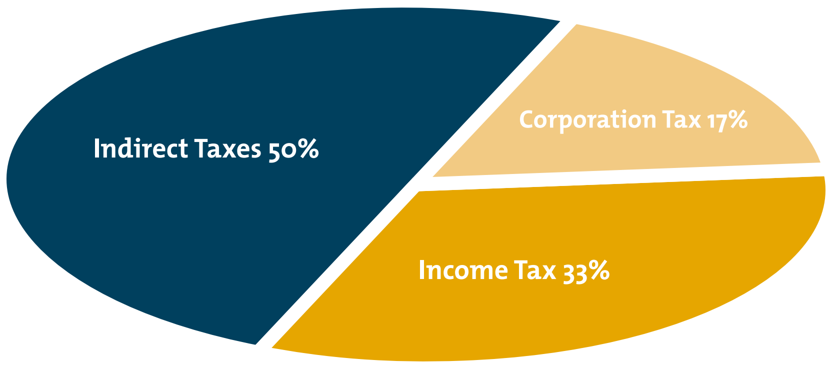
* Note: 2005 figures are provisional

9 Barrett, A. and Walls, C. (2006). *The Distributional Impacts of Ireland's Indirect Tax System*, Combat Poverty Agency/IPA: Dublin.
10 www.revenue.ie

Furthermore, this emphasis on indirect taxes is greater than that found in most other EU countries. Data illustrated above show that total indirect taxes (VAT and excise) in Ireland accounted for 44.7% of total tax revenue in 2004, compared to an EU-15 average of 34.6% and an EU-25 average of 34.8%. This difference of approximately 10 percentage points between the case of Ireland and that of the EU mean represents a difference of more than 29% from the average ratio of direct to indirect tax receipts between Ireland and the EU average.

Taxation policy in Ireland has moved, to some degree, from a model which places high taxes on labour to a model which taxes consumption to a greater extent than before. The rationale of this approach has been justified on several macroeconomic grounds. For example, raising indirect taxes has fewer adverse labour disincentive effects than raising direct taxes. However, the poverty impact of the paradigm shift from direct to indirect taxation has been given relatively little attention. This is a key justification for Combat Poverty's commissioning of new research on the matter.

Figure 2: Proportionate Breakdown of Top Three Tax Revenues in Ireland (2005)[11]



Tax reliefs are another important dimension of the taxation system in that they represent tax expenditures rather than tax revenues. They play a considerable part in reducing the fairness of the taxation system. They form an important policy context to the research findings of the recent Combat Poverty study on taxation. The rationale for introducing a range of tax expenditures and reliefs is normally to encourage economic activity in certain industries and sectors of the economy. However, Combat Poverty has some concerns about some of these schemes, particularly from the perspectives of taxation equity and income distribution[12]. Tax reliefs violate many of the canons of taxation, most particularly the principle of equity which states that people should pay tax in proportion to their ability to pay. Tax reliefs provide high-income individuals

11 Derived from www.revenue.ie
12 For more on tax reliefs and poverty, see: Combat Poverty Agency (2005). *Submission to the Department of Finance Review of Tax Reliefs and Exemptions for High Earners*, Combat Poverty Agency: Dublin.

with opportunities to reduce their effective taxable income substantially. This is at odds with the principles of both vertical and horizontal equity and leads to reduced progressivity in the tax system. Thus, there is a double inequity associated with tax reliefs. On the one hand they reduce the tax base, thereby imposing higher tax burdens on average households not in a position to avail of many tax-relief schemes, and on the other hand they provide high earners with opportunities to avoid paying tax. Moreover, the economic climate has changed dramatically since the initiation of many of these tax expenditures. Combat Poverty argues that several of these expenditures are subsidising economic activity that would happen in the absence of dedicated tax reliefs, resulting in a deadweight loss to society.

Total tax expenditures equate to some €8.38 billion, according to the Tax Strategy Group[13]. Bearing in mind that the income tax take is around €10 billion and the total tax take is close to €30 billion, there is potential scope for the total tax base to be increased by up to 25% in monetary terms if tax reliefs and expenditures were abolished. Closing these tax loops and widening the tax base would provide opportunities to reduce both direct and indirect taxation in Ireland and enhance progressivity further. In this regard, Combat Poverty welcomes the recent 2005 Review of Tax Reliefs and the recommendations that some of these schemes should be discontinued or modified to improve their economic desirability.

III. Indirect Tax Research

Recent research on indirect tax, published by Combat Poverty, demonstrates the degree of progressivity/regressivity evident in the indirect tax system in Ireland. The indirect tax system is found to be regressive in the sense that households in the lowest decile (based on equivalised income) pay a higher proportion of their incomes in indirect taxes relative to households in the higher deciles. Using rates of VAT and excise rates for 2004, the estimates suggest that indirect tax payments for households in the lowest decile amounted to 20.6% of income, while the corresponding figure at the highest income decile was 9.6%.

There are some pro-poor elements already built into the indirect tax system, and the effects of these policies are evident from the simulation analysis. The exempting of food from tax makes the system less regressive. The taxing of fuel at the reduced VAT rate, as opposed to the higher rate of 21%, also reduces the degree of regressivity. There is no distinct pattern of regressivity in the case of clothing and footwear. This is most likely because of the non-taxing of children's clothes and footwear. There is a fuzzy relationship between income and indirect taxation payments on transport. Transport expenditure has been shown to be not linearly related to household income in previous Environmental Protection Agency (EPA) -funded research[14], and this analysis corroborates that work.

The distributional analysis conducted by the authors of the Combat Poverty study indicates that excise duty is proportionately more regressive than VAT, with the poorest income decile spending 130% more than the richest income decile, as a proportion of household income, on excise duty (using 2004 data). The equivalent figure for VAT is 112%[15]. Thus, the poorest tenth of households spend 117% more than the richest tenth, as a proportion of income, on total indirect taxes. Furthermore, the time-series data indicate that the proportion of household income spent in low-income households on VAT and excise payments are increasing over time.

The reduced 13.5% rate of VAT is almost twice as regressive as the standard 21% VAT rate - the poorest income decile spend 177% more than the richest decile spend, as a proportion of household income, on VAT at 13.5%. This can be compared to 98% at the higher rate. This is because low-income households consume more goods, as a proportion of income, at the reduced VAT rate.

IV. Policy Response

Indirect Taxation

The ESRI SWITCH model is widely used to assess the distributional implications of a proposed change in income tax. It is clear that any proposed change to indirect tax should be evaluated using a similar model which clearly demonstrates the equity and distributional implications.

The research indicates that there are some anti-regressive features built into the indirect tax system, specifically:

(a) the non-taxing of children's clothes and footwear;
(b) the reduced VAT rate of 13.5% on food; and

13 Department of Finance (2004a). *Tax Incentives/Expenditures and Broadening the Tax Base*, Tax Strategy Group Paper 04/22. Department of Finance: Dublin.

14 Scott, S. and J. Eakins (2004), *Carbon Taxes: Which Households Gain or Lose*, Wexford: EPA.
15 Barrett, A. and Walls, C. (2006). *The Distributional Impacts of Ireland's Indirect Tax System*, Combat Poverty Agency/IPA: Dublin.

(c) the reduced VAT rate of 13.5% on fuel.

These features should be retained, and further increases in indirect taxes should be avoided on equity grounds. However, the research indicates that the scope of the indirect tax system for redistribution of resources is limited. The main problem in this regard is the fact that very few items are bought exclusively by either low-income or high-income households. If there were identifiable 'luxury' commodities that were bought exclusively by the more well-off, then a high indirect tax could, theoretically at least, be placed on such an item in an effort to raise revenue equitably. Alcohol and tobacco is one commodity group that is consumed proportionately more by low-income households. However, reducing taxes on such items to improve the progressivity of indirect taxation would produce perverse incentives and result in adverse health effects. Efforts to reduce the current rates of VAT and excise duty could, theoretically, improve the progressive nature of the indirect tax system. However, economic theory suggests that the impact of such tax cuts would not be fully passed onto the consumer, but instead would be absorbed by the retailer in an effort to maximise profits. Thus, once indirect taxes are raised, it is very hard to claw back and reduce these taxes. Because of this, there should be no further increases in VAT or excise rates.

There appears to be limited scope to improve significantly the progressivity of the indirect tax system. However, there are potent ways to improve the progressivity of the tax system as a whole, the most conspicuous being the termination of unnecessary tax expenditures.

Tax Expenditures[16]

While the Combat Poverty-funded study on tax was primarily concerned with indirect taxation and equity, one key way to improve the equity of the taxation system as a whole is to broaden the tax base through the closure of unnecessary tax expenditures. Combat Poverty believes that all proposed and existing tax expenditures should be subjected to rigorous (ex post or ex ante) economic evaluation, such as social cost-benefit analysis. Those that do not yield demonstrable economic or social gain should be phased out with immediate effect in an effort to improve the tax base and increase the progressivity of the tax system as a whole. The effect of tax expenditures on poverty rates should be assessed before their introduction. There is a government requirement to assess government policies and proposals for their impact on poverty. Many tax expenditures do not benefit people living in poverty and some may adversely affect people living on low incomes or in disadvantaged areas e.g. through speculative property investment which drives up the price of property further. The consequences

16 For more information on Combat Poverty's position on tax expenditures, readers should consult: Combat Poverty Agency (2005). *Submission to the Department of Finance on the Review of Tax Reliefs and Exemptions of High Earners*, Combat Poverty Agency: Dublin.

on wider society must be considered in full when evaluating such expenditures. Tax-expenditure schemes that are justifiable on economic and/or social grounds should become part of a more systematic, strategic and planned approach (e.g. forming a component of spatial planning).

Combat Poverty argues that there should be a continuation of anti-avoidance or 'base-broadening' measures similar to those introduced in 1998 in which a ceiling on capital allowances that can be offset against non-rental income was introduced. Combat Poverty welcomes the outcome of the recent review of tax reliefs and exemptions for high earners initiated by the Minister for Finance in Budget 2005. In particular, the decision to cap exemptions and to discontinue property-based reliefs after 2007 is very welcome. Combat Poverty also recommends that the recent review should be extended to include all tax expenditures, not just the property-based incentive schemes which are of relatively limited scope. These schemes have the effect of reducing the tax paid by high earners. Even where tax reliefs are seen as economically or socially beneficial, their feasibility should be kept under scrutiny in the context of the general direct taxation system and the need to keep the tax base as wide as possible. Caps or ceilings are a good way of minimising the deadweight loss where there is some societal gain demonstrated in a scheme's retention.

Tax reliefs on pensions have a strong inequity effect, as they benefit primarily those in the top income quintile. Using 2000 data, it has been shown that 65% of employees and 78% of those self-employed in the top income quintile claim tax relief on private pensions, while less than 3% of employees and virtually no self-employed individuals in the bottom income quintile avail of such reliefs[17]. A positive, linear distributional relationship is illustrated by Hughes with regard to household income and pension tax reliefs. In addition, there is some evidence that pension tax relief is being used to leverage property investments, which was not its original purpose[18]. Tax relief on private pensions should be reviewed on an ongoing basis with particular regard to the inappropriate use of pension relief[19].

Direct Taxation

A second area that the study highlights is the need to maximise the progressivity of direct taxation on incomes and to make work pay for low earners. This is an area in which there has been much success over the last decade. Ireland now collects 29.6% of total revenue in the form of income tax. This is considerably below the EU average, and a far cry from the relatively high income tax wedges during the fiscal rectitude period

17 Hughes, G. (2005). 'Pension Tax Reliefs and Equity', in Stewart, J. *For Richer, For Poorer: An Investigation of the Irish Pension System*, TASC: Dublin.
18 See Minister for Finance Brian Cowen's 2006 Budget Speech (www.budget.gov.ie).
19 For more on pensions and equity, readers should consult: Combat Poverty Agency (2005). *Submission to the National Pensions' Board on the National Pensions' Review*, Combat Poverty Agency: Dublin.

of the 1980s. Supporting people to move into quality paid employment is beneficial from a poverty perspective, as this is one of the best routes out of poverty. Combat Poverty argues that efforts in this regard should continue in particular towards increasing the proportion of taxpayers who pay no tax and those who pay tax only at the standard tax rate of 20%. Both policies would assist low-income working families in making ends meet.

Corporation Taxation

Ireland collects a relatively small proportion of revenue in the form of corporation tax. In 2005 15.5% of total revenue was in the form of corporation taxes. This is about the same level as that collected five years earlier in 2000[20]. The prospect of tax harmonisation of corporation taxes has serious implications for Ireland in terms of the potentially damaging effect it could have on foreign investment, jobs, growth and competitiveness. However, there is a counter-argument, formed on the grounds of taxation equity, which states that, under a scenario of EU-wide tax harmonisation, Ireland could collect a more just proportion of its total tax take in the form of corporation tax, with less burden on consumers (in the form of indirect taxes) and workers (through income taxes and social security contributions). It should be acknowledged, however, that the low corporation tax model in Ireland has been a key factor in attracting foreign domestic investment and subsequent economic growth. In addition, the recent ESRI Medium Term Review has highlighted that there is limited scope for increasing corporation taxes without potential adverse repercussions[21].

20 Eurostat (2005). *Tax Revenue in EU Member States: Trends, Levels and Structures 1995-2003*, European Commission: Luxembourg.
21 ESRI (2005). *Medium-Term Review 2005-2012.* ESRI: Dublin.

PROMOTING EQUITY IN IRELAND'S TAX SYSTEM

V. Conclusion

Taxation provides a means to generate revenue for social expenditure and to redistribute resources to those in society who need them most. A new balance has emerged in recent years between the ratio of tax revenue collected in the form of direct, indirect and corporation taxes. Ireland has pursued a model of low direct and corporation taxes, with an increased emphasis on indirect tax take.

Indirect taxes are inherently regressive because they do not take into account the ability of the taxpayer to pay the tax.

Recent research commissioned by Combat Poverty, outlined in this Policy Statement, sheds important new light by quantifying the burden of indirect taxes and the attendant degree of regressivity facing low-income households in the form of VAT and excise duties. Thus, a greater emphasis on indirect taxes as a means of revenue generation means that the system is less equitable overall. Because of this, indirect taxes should not be increased, in the interest of taxation equity.

As there is little that can be done to improve the progressivity of the indirect tax element effectively, the emphasis should be on broadening the tax base. The curtailment of tax expenditures would support this objective. Combat Poverty has argued that tax expenditures need to be reviewed on an ongoing basis and acknowledges the positive steps announced in Budget 2006 with regard to tax reliefs[22]. Combat Poverty recommends that policymakers should implement the base-broadening recommendations of the three reviews of tax schemes published by the Department of Finance in 2006[23].

22 Combat Poverty Agency (2005). *Submission to the Department of Finance on the Review of Tax Reliefs and Exemptions for High Earners*, Combat Poverty Agency: Dublin.
23 See Department of Finance (2006). *Budget 2006: Review of Tax Schemes Volumes I-III*, Department of Finance: Dublin.

Combat Poverty Agency
working for a poverty-free Ireland

Bridgewater Centre, Conyngham Road, Islandbridge, Dublin 8
Tel: 01 670 6746 Fax: 01 670 6760 Email: info@cpa.ie Website: www.combatpoverty.ie