Statement to the Committee on Budgetary Oversight; November 9th, 2022

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ESRI

Let me begin by thanking the Chair for the invitation to the ESRI to appear before the Committee. I am Dr. Karina Doorley. I am joined by my colleagues Prof. Martina Lawless and Prof. Conor O'Toole. We are happy to provide our views on the report of the Commission on Taxation and Welfare. Over the course of a year, the Commission prepared a thorough and evidenced-based examination of the suitability and sustainability of the taxation and welfare systems in Ireland. One of the Commission's key findings was that, in light of challenges such as population ageing and climate change, the "overall level of revenues raised from taxation and Pay Related Social Insurance (PRSI) as a share of national income will have to increase materially over the coming years." This theme underlies many of the recommendations made in Chapters 6, 7, 8 and 14, on which we will focus today.

Broadening the tax base

Chapter 6 of the Commission's report discusses the need to broaden the tax base. In Ireland, low-income earners pay relatively less income tax than in most EU countries as the system of tax credits leaves many low-income workers exempt from income tax. Conversely, high income workers pay relatively more tax by international standards as the top rate of tax kicks in at a relatively low level.[1] This means that income tax receipts may be volatile in nature as a large proportion of revenue comes from a small number of taxpayers.[2] The Commission concludes that, thanks to reforms to the income tax system and the introduction of the Universal

[1] Taxing Wages 2017, OECD 2017

[2] The Parliamentary Budget Office reported that, in 2018, the top 25% of income earners paid around four-fifths of all income tax and the top 1% of earners paid more than one-fifth of income tax receipts.

Social Charge during the financial crisis, the tax base is sufficiently broad but should not be further eroded. A key recommendation of the Commission however is to harmonise income taxation such that there are no differences in how it is levied by age of the earner or by source of the income. This would promote horizontal equity and increase taxation revenue. It would also facilitate revenue raising in an equitable and broad-based manner in the future if rate increases are deemed necessary.

Consumption taxes also present an opportunity to increase tax revenue while reducing economic distortions. Ireland is an outlier in Europe due to our extensive use of reduced and zero VAT rates. Both the OECD and the EU commission have repeatedly recommended broadening the VAT base in order to stabilise VAT revenues. The Commission recommends gradually increasing the reduced rate of VAT of 13.5% and increasing the second reduced rate of 9% to 13.5%. This joint increase is likely to be regressive in nature so consideration may need to be given to using a small share of the revenue raised for compensation mechanisms through the welfare system. The Commission also recommends that temporary VAT rate reductions should not be used as short-term stimulus measures as there is significant deadweight associated with such policies and there is much international evidence that reductions are often not passed on to consumers.[3]

Taxes on Retirement Savings

The current system of taxing retirement savings can be broadly classified as Exempt, Exempt, Taxed (EET). By deferring taxation on retirement savings until the income is drawn down in retirement and the marginal tax rate is likely to be lower, the EET system is considered more effective at incentivising retirement savings than a TEE system, which frontloads the tax. The possibility of withdrawing a tax-free lump sum on retirement increases this incentive in the Irish context. However, the system of is characterised by a low level of contributors and contributions.[4]

The Commission recommends that certain features of the system be reformed such as the facility to extract tax-free lump-sums, which is a deviation from the strict EET framework and

[3] Benzarti, Youssef & Carloni, Dorian. (2019) Who Really Benefits from Consumption Tax Cuts? Evidence from a Large VAT Reform in France. American Economic Journal: Economic Policy. 11. pp. 38-63.

[4] Collins and Hughes (2017) estimated that 34% of earners made a pension contribution in 2014 and that one-third of the contributions represented less than 5% of earnings.

results in lower tax receipts while mainly benefiting high income individuals. The Commission also recommends the removal of age-related contribution rates given the changing nature of work and equity considerations.

Taxes on wealth and wealth transfers

The Commission's report recommends against the introduction of a new tax on wealth, concentrating instead on recommendations to increase revenues from existing taxes on capital transfers such as Capital Gains Tax and Capital Acquisitions Tax.

The taxation of wealth has been widely discussed internationally in recent years, but few countries have a recurring tax on wealth. Wealth is more concentrated than income with the top ten percent of households holding half of total net wealth. The Gini coefficient measure of inequality is about twice as large for wealth as it is for income, giving rise to equity arguments in favour of a tax in this area. Although higher income households are more likely to have higher wealth, income and wealth are not perfectly correlated which would have implications for the distribution of any tax on wealth. In particular, older households who have paid off any mortgage debt on their property are typically wealthier than younger households. However, wealth taxes are complex to implement with the potential revenues varying considerably depending on the liability threshold, exemptions and the tax rate itself. The need for regular valuation of a wide range of assets and potential negative incentives to move financial assets pose implementation challenges.

For these reasons, the Commission instead focuses on recommending changes to other capital and property taxes. Currently revenues from capital acquisitions taxes make up less than one percent of total exchequer receipts. The receipt of inheritances is one factor that contributes to a different distribution of income and wealth across households. ESRI research showed that typically a household that received an inheritance would be 15 percentiles higher in the wealth distribution than a household at the same income level that did not receive an inheritance.[5] Reductions in the thresholds for liability to Capital Acquisitions Tax and changing the main residence exemptions to Capital Gains Tax would widen the coverage of both.

[5] Lawless, M. and D. Lynch (2017). Gifts and inheritances in Ireland, ESRI Working Paper WP579, Dublin: ESRI, https://www.esri.ie/publications/gifts-and-inheritances-in-ireland

There is also considerable overlap in taxing wealth and taxes on property. According to the most recent statistics available, the main residence accounts for just over half of total assets held by households and other properties and land make up a further twenty percent.

The Commissions' Consideration on Land and Property

Following on from this context, the Commission was tasked with considering the role of the taxation and welfare system in achieving housing policy objectives, with a particular emphasis on the merits of introducing a Site Value Tax (SVT). The considerable challenges experienced in the Irish housing market over the past decade have been well documented but can be broadly characterised as acute bottlenecks in housing supply and affordability difficulties in particular for new market entrants and low to middle income renters (in particular in urban areas).[6] There are multiple factors which are affecting the supply of, and demand for, housing in Ireland (such as planning, construction sector capacity, general economic pressures, credit access for buyers and producers, and financial crisis overhangs). While many of these are outside the scope of the work of the Commission, a range of levers within the broad fiscal policy architecture are considered and are worthy of comment.

As a general point, the Commission suggests the deployment of a taxation system for housing that is longer term in nature, acts to stabilise prices and discourages the use of measures which act to stimulate the construction sector on a short-term basis. The emphasis on this transition is welcome as considerable volatility has been a feature of the Irish housing market for the past two decades (in terms of observed prices and rents as well as new supply). The core element of this transition is a refocusing on taxes on immovable property rather than property transfers which they state will improve efficiency and reduce inequality.

Within this context, they recommend the introduction of a (SVT) (or land value tax) that would be levied on all land not subject to the residential local property tax (with differential treatment for agricultural land and some other limited exemptions). The aim is to increase the efficiency of the land market, support density, and encourage productive land usage. The Commission also noted that any SVT could accommodate the principle of the Zoned-Land Tax (which imposes a tax on zoned, but undeveloped lands) by increasing the SVT tax rate on these sites.

[6] Corrigan, Eoin, Foley, Daniel, McQuinn, Kieran, O'Toole, Conor and Slaymaker, Rachel, (2019), Exploring Affordability in the Irish Housing Market, The Economic and Social Review, 50, issue 1, p. 119-157.

This would be important as a tool to activate housing supply. They also recommend continuing (with some changes) the existing local property tax system.

While introducing a SVT could bring the noted benefits, the major challenge would be how to design and calibrate the measure (for example what level to set rates, how to develop exemptions etc). Bridging data gaps in terms of the land market and land holdings would be essential as would the methodology used to value the land units: for example, how are the land values to be set in areas where there are very few transactions to provide price and valuation information? A more detailed and specific review would be needed, with further exploration of international examples, to scope out any steps forward towards the implementation of this important initiative.

Final remarks

We thank the committee for their time and the opportunity to discuss this important review and we look forward to answering related questions.