22nd February 2023

Nevin Economic Research Institute (NERI) opening remarks to the Oireachtas Select Committee on Budgetary Oversight

Re Report of the Commission on Taxation and Welfare (COTW) Report – Chapters 9, 10, 11 and 12

Introduction

On behalf of the NERI I would like to thank the Select Committee for the opportunity to discuss these Chapters of the COTW report. I am joined today by my NERI colleagues Ciarán Nugent and Chris Smart.

The report has rightly taken a high level systems approach. It makes clear that Ireland's fiscal position will deteriorate meaningfully over the next two decades and that the overall revenue yield will need to increase materially over the medium-term in order to address the growing fiscal gap.

Adequacy

How well is our system of income supports and subsidised public services performing in its core job of protecting households from income inadequacy? The enforced deprivation rate is a useful proxy for income inadequacy and a measure of failure to adequately protect households.

The proportion of people living in enforced deprivation increased from 13.8% in 2021 to 17.1% in 2022. Children have a one in five probability of deprivation (20.1%), whereas it is closer to one in nine for retired people (10.9%). Certain cohorts are particularly vulnerable. Persons living in one-adult households with children under 18 have a 45.4% probability of deprivation; persons unable to work due to a disability have a 42.7% probability of deprivation, while renters have a 34.1% probability.

The surge in inflation in 2022-23 and the decision not to index welfare rates in the budget will worsen these numbers in 2023.

The report's key recommendations on adequacy argue for:

- Regular evidence based benchmarking exercises and multi-annual targets for working age payments.
- Reform of working age payments to ensure an integrated and coordinated system based on adequacy
- A new enhanced working age payment and a 2nd level of child income support both tapered by income.

The NERI welcomes each of these recommendations.

The new lower nominal rate of employee PRSI is likely to be one the most controversial recommendations. It is important that marginal effective tax rates (METRs) remain low for low-wage households. In addition, there is a clear concern that this recommendation will disproportionately impact low income households. It should therefore only be implemented alongside the key adequacy recommendations.

The report recommends that all cliff edges in the tax and welfare system should be removed. Cliff edges create labour market distortions and can lead to perverse incentives for employees and employers. The recommendation is effectively saying that cash payments, or access to other benefits, should not be lost due to some arbitrary threshold such as employment status or the number of days worked. Instead, only income should determine whether someone qualifies.

Horizontal equity

The NERI welcomes the key recommendation that PRSI on self-employment (Class S) should be aligned over time with the employer's rate of Class A. This continues the COTW's core theme of horizontal equity and it aligns with the need to remove labour market distortions whereby similar activities are treated in different ways. Distinctions between legal forms should be eliminated for tax purposes.

Benchmarking

The NERI supports the recommendation that government undertake a regular benchmarking exercise in respect of all working-age income supports including supports for the unemployed, people experiencing disabilities, and people parenting alone.

Benchmarking would be a welcome reform as it would finally lead to income supports having some transparent basis in evidence. The Pensions Commission made a similar recommendation in relation to the basic pension.

A benchmarking process would need to consider a range of questions:

1. Should there be a once-off process with benchmarks set for each of the different income supports or is an ongoing benchmarking commission necessary?

The NERI's view is that there should be a permanent advisory benchmarking commission that would adjust benchmarks over time based on emerging evidence and practical experience.

2. What should we benchmark payments against?

There are a number of plausible benchmarks. These include A) median wage, B) median income, C) price inflation or D) a derived indicator linked to an individual or household's minimum essential standard of living (MESL). A composite benchmark based on a dashboard of indicators could also be considered.

Benchmarking to price is unsuitable as income supports would fall increasingly behind average wages over time. As such, living standards for those dependent on working age or old age supports would increasingly fall behind the rest of society.

Benchmarking to the median wage has a number of advantages. In particular, it ensures that rates are set cognisant of potential employment impacts. The main argument for using an MESL metric as a benchmark is straightforward. It is cost of living rather than wages that determines an adequate income and therefore the logic goes that only the cost of living is an appropriate benchmark for adequacy.

Working Age Assistance Payments and Enhanced Child Income Supports

The NERI welcomes the recommendation of a new and tapered working age assistance payment available to all households including those without children. Moving to a system of working age payments based on household income rather than employment status or any other arbitrary threshold, such as days worked, would help minimise employment disincentives. The tapered structure is crucial as it ensures that marginal effective tax rates remain low.

The recommendation that child benefit remain untaxed is welcome and consistent with the findings of previous bodies set up to examine the issue. In addition, the current high rates of child poverty and associated consequences indicate that Ireland's current model of child income support is failing. We therefore strongly agree with the recommendation of an additional tier of income tapered child income support.

Pay related benefits

Our view is the case for income related social insurance is actually stronger than that outlined in the report. Income related social insurance provides a form of temporary security that enables better job matching. This reduces over-qualification and ensures better utilisation of human capital. Reduced risk aversion also makes people more likely to start a new business or otherwise engage in entrepreneurial activity.

Income related social insurance also dampens the amplitude of recessions via consumption smoothing. Pay related unemployment benefits help preserve aggregate demand and therefore protect other people's jobs during a downturn.

We also note that Ireland is out of line with Western European norms when it comes to aggregate tax and social contributions and benefits. Ireland raised just 37.4% of GNI* in government revenue in 2019 compared to 40.1% of GDP for the EU. The explanation is that Irish employer social contributions are very low (4.4% of GNI* compared to 8.2% of GDP in the EU).

Chapter 9: Enterprise

While the supports many of the stated aims of Chapter nine, there are also many aspects which we find problematic.

The other seventeen chapters make consistent acknowledgement of the need to minimise tax expenditures and differential tax treatment. This is intellectually consistent with the COTW's stated principles of efficiency and horizontal equity. The disadvantages of tax expenditures (non-transparent, uncertain cost, regressive, economically distortive, characterised by deadweight) are set out repeatedly in the report, which concludes that they should only be used in very exceptional circumstances.

In our view, this approach is correct. However, this approach is effectively set-aside in chapter nine. Instead there is a series of recommendations supporting a range of very generous tax expenditures, and low tax rates for enterprises and/or high earning individuals.

While in some limited and special cases these types of reliefs may individually have an economic justification, collectively they undermine the approach taken in the rest of the report.

For example, the Special Assignee Relief Programme (SARP) makes a mockery of any notion of vertical equity. Such measures make it much more difficult to advocate for necessary tax reforms in other areas. Why should people accept the need for their taxes to increase when they can see that the very rich are treated much more generously? The political economy of raising taxes over the next decade will be extremely challenging and the content of this chapter risks undermining much of the good work of the other chapters.

In our view, the overall balance between fairness and potential efficiency gains is not achieved. The NERI therefore does not support this chapter.