Response to the SCBO Report on Indexation of the Taxation and Social Protection System

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NERI Opening Statement to the Select Committee on Budgetary Oversight

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Ciarán and I thank the Cathaoirleach and the members of the Select Committee and its staff for the opportunity to appear before you today, to discuss the recommendations contained in the Committee's *Report on Indexation of the Taxation and Social Protection System*. We will comment upon the report itself and discuss recommendations, updates, and developments in the intervening period.

Rationale for Indexation and Comments on the SCBO Recommendations

The Committee's Report was broadly supportive of the principle of indexation. The NERI's view is that indexing all social assistance payments to various appropriate benchmarks - including child, working age and pension payments and indeed the income thresholds for benefits - is the most efficient way to design the welfare system if we are genuinely serious about ensuring adequacy and eliminating deprivation and doing so in a manner consistent with fiscal sustainability.

Indexation should apply to all benefits and thresholds if it is to apply to any payments and thresholds.[1]

[1] Any indexation review or reform to the welfare system should consider the effectiveness and appropriateness of the existing design of the welfare system and associated benefits and thresholds. For example, the Commission on Taxation and Welfare noted the existence of a swathe of cliff-edges, arbitrary rules and inconsistencies in the welfare system that potentially generates a range of distortions and inequities. Thus, the need for reform goes well beyond merely benchmarking and indexing.

Price indexation is generally insufficient because it will only keep living standards at their current level but never improve them.[2] For this reason, indexation to wages or to economic growth is preferable, and even then, it is only sufficient if the relevant rate, e.g. the pension rate, is already at or above its adequacy threshold. Indexing to price inflation will also see inequality increase over time as welfare benefits will fail to keep pace with labour income and capital income in most years.

On the other hand, wage indexation to something like a percentage of median weekly earnings[3] would anchor welfare rates to developments in the labour market thereby minimising the risk of unintended distortions. In addition, growth in wages means higher tax receipts from labour and consumption taxes. Thus, linking social assistance rate increases to increasing wage rates means de facto linking them to increasing fiscal capacity and to developments in the wider economy.

Ultimately, any benchmarks for sufficiency will have to be based on the cost of living for various cohorts.[4][5]

Once an appropriate set of benchmarks is established for each of the welfare rates there would need to be a two-stage process. The first stage would see welfare rates converging on the benchmark, as is currently the case with the new national minimum wage which is benchmarked to 60% of the median wage. Once the benchmark is achieved, the second stage begins and annual growth in the rate is then indexed to growth in the selected benchmark.

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[2] Headline inflation rates such as the CPI may underestimate cost of living increases for lower income households. CSO analysis showed that this was indeed the case during the early stages of the surge in inflation in 2022 as lower income households spend proportionately more on affected areas like energy and food. In addition, lower income households have been disproportionately impacted by the surge in recent years in the cost of housing and particularly rent.

[3] Median weekly earnings were €670.90 in 2022 and were close to €682 in 2023 assuming the median wage grew in line with average wage growth.

[4] The body tasked with establishing the appropriate benchmarks will have to take a dynamic view of evolving living costs over time and of the potential role of different policy interventions. For example, increased provision of, or increased subsidisation of the costs of, universal basic services such as education, health, childcare and public transport can reduce the cost of living for cohorts at the lower end of the income distribution.

[5] This does not invalidate indexation to the median wage as the benchmark can be set at any percentage of the median wage.

Income smoothing over a two to three-year period can be used to ensure that real welfare rates do not deteriorate if real wages fall, but also that the rates do not become decoupled from the benchmark over time.[6] There are a range of ways to approach income smoothing and various arguments for and against forward and backward-looking approaches to indexation. We are happy to discuss further.

The case for indexing the tax system is more contentious. Non-indexing the tax system will of course marginally increase the effective rate of tax on labour income for those middle and higher earning individuals earning enough to be captured by higher rates. On the other hand, non-indexation or 'bracket creep' will add to government revenues over time and will do so in a way that is less politically fraught than increasing tax rates on things like carbon or VAT or introducing new sources of revenue such as a site value tax or water charges.

This fact is particularly pressing given the key finding of the Commission on Taxation and Welfare (p.67)[7] that *the overall level of revenues from tax and PRSI as a share of national income must increase materially to meet future challenges to fiscal sustainability*.

The mixed political reaction to that report shows just how difficult it will be to achieve this. A final point here is that non-indexing of the tax system does not pose the same existential adequacy issues for households that is posed by non-indexation of the welfare system.[8]

[6] Forecast price inflation would effectively become the floor for annual increases but gains relative to real wages would then be clawed back over time so that the rate falls back to the adequacy benchmark were it to exceed it. In other words, the growth in welfare rates would not necessarily be identical to growth in the median wage in each individual year but would instead track its growth over the medium-term.
[7] Commission on Taxation and Welfare (2022) Foundations for the Future: Report of the Commission on Taxation and Welfare.
[8] Excises duties are an exception to the principle that price indexation should not be used as the basis for indexation. Excises on commodities such as alcohol, cigarettes and carbon are generally taxed per commodity unit. Thus, if the excise is not increased in line with the price of the commodity the effective rate of tax will actually decline and their relative price will decline compared to other goods. On the other hand, indexing to wages will see the relative price increase over time as wage growth will generally exceed price growth over the longer-term.

Indexation around the World

The IMF[9] has put together a new 2023 dataset on indexation in public finances around the world. 115 out of 192 countries have at least one form of fiscal indexation.

- They find that pension indexation is most common in Europe. Globally, 40 countries index to prices, 15 countries index only to private wages and 38 countries have some form of mixed indexation (93 countries in total).
- Other social assistance indexation is most common in advanced economies. 31 countries have some indexation to price and 15 have some indexation to other variables (46 countries in total).
- Indexation of personal income tax thresholds is less common. 18 economies automatically adjust thresholds and another 16 regularly do so (34 countries in total).
- Finally, public wages are the least likely to be indexed with very few countries doing so. Some of these countries index public wages to prices while others index to variables such as growth.

Updates and developments

The Commission on Taxation and Welfare was clear in its analysis in its 2022 report that it saw benchmarking social assistance payments and thresholds as the 'key' necessary reform to the welfare system. Specifically, it recommended (p.295) that *Government <u>undertakes a regular benchmarking exercise</u> of all working age income supports (including supports for people who are unemployed, people with disabilities and people parenting alone), following which <u>multi-annual targets should be set for social welfare rates</u> which provide for regular incremental progress. Annual increases in social welfare rates should be based on a transparent and evidence-led process.*

[9] IMF (2023) Inflation Indexation in Public Finances: A Global Dataset on Current Practices, WP/23/264.

Its view was that the adequacy of social welfare rates is central to poverty reduction. This implies different rates to reflect e.g. cost of disability for various cohorts. Crucially, the Commission also argued (p. 269) that secondary benefits for people of working age should be designed on a cross-departmental basis to ensure policy coherence and to assess the cumulative impact of all benefits, thresholds and cliff edges.

Any independent indexation body would ideally liaise on an ongoing basis with such a cross-departmental group. The process of reforming existing structures and benefits and adopting the Commission's various reforms[10] would ideally precede the multi-annual two-stage indexation process.

Good quality data on household income and household spending will be crucial.

Unfortunately, the Government's response to the cost of living crisis and the subsequent rise in the deprivation rate over the last two years has shown clearly the inadequacy of the tools being used by Government to protect against poverty and deprivation. Despite being advised by a range of NGOs and national and international institutions to adopt a targeted approach to the cost of living crisis the Government persisted with a slew of untargeted once-off measures and inflationary tax cuts including to households that were in no danger of poverty or deprivation and at a time of record net household wealth.

Once-off measures were an entirely inappropriate response to a cost of living shock. The reality that the increase in the cost of living was structural, cumulative and permanent was either not acknowledged or, when it was, it was stated that we didn't have the state capacity to make appropriate targeted interventions. Policy failed because it did not have a benchmarking and indexation process in place. We need to be able to do better next time.

[10] The commission argued that working-age payments should be reformed to move towards an income related and tapered working age assistance payment available to all households. It also argued that a second tier of child benefit be introduced that combines existing supports and that would be provided to all low-income households on a tapered basis, whether in receipt of a social welfare payment or not.

Of course, indexation has now entered the policy tool kit with regard to the national minimum wage. This reform was perhaps prompted by the need for Government to come into line with the EU's Adequate Minimum Wage Directive which sets a target of 60% of the median wage. The indexation of the minimum wage makes it easier to index social welfare rates as they can be calibrated multi-annually to ensure there are no labour market disincentives inadvertently created.

Concluding Thoughts

Benchmarking and indexation are important policy tools that can improve well-being and reduce inequality, poverty and deprivation. Properly designed and coupled with other policies these tools are consistent with fiscal sustainability and indeed with wider labour market goals. In practice, an independent ongoing body including civil servants, NGOs and academics should be established to determine appropriate benchmarks for the various rates, and to recommend to Government as part of the budgetary process.

A clear process of indexation will enhance budgetary transparency and improve the quality of the national debate about poverty, distribution and fiscal impacts but, at the same time, the recommendations should be treated as such and need not tie the hands of elected representatives. However, even with this discretion automatic indexation would become a de facto baseline against which policy is assessed rather than the current 'no-change' baseline we use at present.