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Tax and Welfare

Building Better Systems in the Context of Looming Megatrends and Rising Challenges

If we are to achieve and maintain thriving societies and economies we will need the base of well-functioning tax and welfare systems.

Tax policy has profound implications for individual and corporate behaviour and it shapes outcomes in terms of economic development, distribution and sustainability. Tax policy also shapes our collective possibilities in terms of the envelope of public spending.

Public spending is the other side of the fiscal coin. We can justify it to the extent it contributes to an agreed public policy goal. An improvement in societal well-being is an obvious high-level example of a potential goal but there will be others such as eradicating poverty, preventing a deterioration in the global climate, or preventing biodiversity loss.

Public spending can be justified to the extent it achieves agreed public policy goals

In practice, our goals underpin and justify spending on merit goods such as education, health, public transport and public R&D. They also justify spending on public goods such as the environment, infrastructure, justice and defence, and on welfare payments such as unemployment insurance, disability supports and pensions. Such payments are the bedrock of the welfare state but need to be supplemented with universal public services and access to basic necessities like affordable housing.

Even so, the mere fact that spending on these areas can be justified from a public policy perspective does not tell us how much should be spent or indeed in what way it should be spent.

This is the 8th in the NERI series of policy long-reads. The essay will briefly assess the short-and-long-term fiscal policy challenges for the Republic of Ireland within the context of certain assumed economic and social goals. Most of these challenges and all of the goals apply equally well to Northern Ireland and indeed to many other jurisdictions.

The piece then outlines the appropriate goals and design principles for tax policy and briefly discusses broader welfare policy including the social wage, the role of universal services, and the need for of benchmarking.

Tax policy shapes outcomes in terms of distribution, economic development, and sustainability across a range of dimensions

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When thinking about tax and spending policies we first must consider short-term and medium-to-long-term contexts, goals and challenges. The first challenge is fiscal sustainability. Is the government's revenue base adequate and resilient to meeting evolving public spending needs and demands in the short-term and then again in the long-term?

We are immediately confronted with choices and trade-offs. Our demands for better funded public services in areas like health, education and social protection may well be insatiable but our economic and political capacity to generate tax revenues is inherently limited by our resources. Political systems, political parties, media and special interest groups often downplay this fundamental truth with unfortunate consequences for stability.

The short-run fiscal context in the Republic of Ireland appears ostensibly benign, at least as of late 2023. There is a fiscal surplus and a falling debt ratio. However, this surplus disappears once 'excess' and potentially transitory corporation tax (CT) receipts are excluded. It is notable that excluding the windfall CT receipts leads to a modest deficit in 2024.

However, the medium-to-long term fiscal position is much less benign due to a combination of domestic and global mega trends that are expected to impact on European and other economies over the next few decades.

Perhaps the most fiscally significant of the trends is the projected ageing of the population. Such ageing is inevitable unless here is very significant and ongoing net inward migration. Ageing demographics will change consumption patterns and demand for public services. In particular, there will be increased demand for spending on healthcare and pensions and less demand for spending on education. Overall, the demographic trends will increase public spending demands on a per person basis.

At the same time, the working age ratio is set to decline. This decline will have a number of effects beyond changing consumption patterns. Notably, a falling working age ratio means lower average potential growth rates. Lower working age ratios also mean less tax revenues generated per person, particularly from taxes on labour. In sum, the demographic shift will mean higher public spending and falling revenue per person.

A second fiscal challenge arises from green transition and adaptation costs. Climate action by government including investment in green infrastructure and green tech could cost 1.1% of national output (GNI*) per annum for the next few years with perhaps half that amount per annum between 2030 and 2050. Climate action will also need to adhere to just transition principles if it is to be politically sustainable. This implies new public spending commitments in areas ranging from and not limited to - housing retrofits; expanded provision of affordable public transport; income and training supports for affected workers in declining 'brown' sectors, and increasing subsidisation of environmentally friendly land use and eco system services.

A related and crucial point is that success in meeting climate targets will create a hole in the public finances of as much as 1.6% of GNI* in the long-run. This is because many sources of tax receipts would collapse. Examples include receipts from motor tax, carbon, petrol and diesel. Alternative sources of revenue will be needed.

Other mega trends may have important fiscal impacts. For example, de-globalisation may lead to a weaker flow of FDI into traditional beneficiaries such as the Republic of Ireland and consequently to weaker employment and tax flows.

The fiscal impacts of technological disruption, whether from automation, from artificial intelligence, or from green tech, are unclear. These disruptions and others imply that economic success in the future will be increasingly contingent on-ongoing, large-scale and tailored public investment in education and life-long learning particularly in areas such as digital skills and STEM education.

Another potential fiscal challenge is that interest rates may be structurally higher in the 2020s and 2030s than they averaged in the 2000s and 2010s. If this were to be borne out it would impact on the cost of borrowing with consequences for countries with large debt burdens or those that are persistently running large deficits.

The threat of rising wealth and income inequality and in particular rising intergenerational inequality creates a further potential challenge. Greater inequality may be associated with a range of negative quality of life and well-being impacts across the economy and society. Inequality intensifies distributional conflicts, thereby making societies inherently unstable, and it reduces demand in the economy by shifting income to savers. Tax and welfare systems will generally need to do more ameliorative work where there is high and/or growing inequality.

Finally, we should recognise our starting context. Previous work by the NERI and by the Commission on Taxation and Welfare (COTW) shows that

Domestic and global mega trends are going to cause major fiscal sustainability problems government revenue in the Republic of Ireland is low by Western European standards when measured as a percentage of output (GNI* basis). The United Kingdom is similarly below average. Many of these higher tax Western European peer countries are regularly ranked amongst the most competitive in the world. There is only very limited compelling evidence that tax-to-output ratios causally influence long-run growth, if at all, particularly once the opportunity cost of reduced spending on areas like education is considered. This suggests there is at least some scope to increase taxes without sacrificing economic growth potential.

On the other hand, the composition and structure of the tax base and of public spending does seem to matter for growth. For example, the growth impact of spending on education is not equivalent to the growth impact of spending on defence. Similarly, increasing taxes on land and property will have different (lesser) growth impacts to increasing taxes on income.

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Before continuing it is first worth considering our core goals. Economists often focus on economic growth. In fact, the core goal is actually much more nuanced than that. Growth must be inclusive and it must be sustainable across all dimensions from environmental to fiscal. We discuss this in greater depth in other NERI research, but in essence what we are striving to achieve is ongoing and sustainable well-being and living standard improvements for all. The Republic of Ireland, Northern Ireland and many OECD countries have variously developed well-being frameworks and research that helps structure this discussion.

The goal is more nuanced than 'growth' – we want sustainable well-being and living standard improvements for all

There will always be legitimate debates about the appropriate level and composition of taxation and public spending. Let us start on the revenue side. It can be helpful to develop some guiding design principles which are consistent with our core goals. The COTW identified five such principles (1) Sustainability; (2) Reciprocity; (3) Adequacy; (4) Equity and (5) Efficiency. The desirability and wisdom of a potential tax reform can then be judged on whether it makes the overall system more closely adhere to this multi-dimensional set of often conflicting design principles or 'tests'.

Each principle can itself be unpacked into multi-dimensional subcomponents. The equity principle includes horizontal and vertical equity. Horizontal equity is the idea that persons or groups with the same taxable capacity, or ability to pay, should be treated equally and pay the same amount of tax regardless of age or other consideration. Vertical equity is synonymous with the idea of progressive taxation i.e. that a person with higher income or wealth should pay more in taxes than a person with less income or wealth.

Efficiency relates to the potential for distortive effects arising from tax types, rates and structures on employment, investment and growth. It also refers to simplicity which is central to administrative and compliance cost and efficiency. Important insights arising from this principle suggest low rates, wide bases and a minimisation of the use of tax expenditures to the greatest extent possible.

Sustainability has obvious fiscal and environmental components but also refers to what is acceptable from a political economy and social cohesion perspective. The fiscal and political sustainability of any given tax system is a function of the political demand for public spending, the need to provide merit goods and public goods, and the willingness to pay taxes. More salient taxes such as property taxes tend to be less politically sustainable than hidden taxes such as VAT even though they tend to be more progressive and less economically damaging.

Adequacy tends to have more relevance to policy considerations on the welfare side but nevertheless has some relevance on the taxation side. For example, this principle argues against high income tax rates for low earners as this could reduce incomes below minimum adequate levels. The principle also argues against consumption taxes on necessities such as healthy food.

Reciprocity is the most esoteric of the five principles. It relates to the notion that we are 'all in it together' and that there is a social contract entailing rights and obligations between the individual and the rest of society. One implication is that everyone should contribute to the state by paying taxes at some minimum level.

A sixth principle is that the tax system should be ethical. This implies that tax policy should not harm individuals or groups of people whether by being confiscatory or by undermining the tax systems of other countries.

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Moving beyond design principles brings us to consideration of the composition of the tax system and to particular tax types and potential reforms. In general, taxing an activity should lead to less of that activity. This implies merit goods and goods with positive externalities should be taxed at relatively low rates or perhaps not at all.

It also implies demerit goods and goods with negative externalities should be taxed at relatively high rates. Demerit goods and services are products which can have a negative impact on the user. Examples include alcohol, cigarettes and gambling. A negative externality is a cost that affects someone other than the producer or consumer. Air pollution, traffic, greenhouse gas emissions and biodiversity loss are good examples of negative externalities.

On the other hand, activities that provide positive externalities are perhaps the sole examples of where tax expenditures are justifiable. The classic example relates to the economic characteristics of knowledge and the production of new knowledge through research and development (R&D). In short, the social benefit to new ideas outweighs the private benefits and this leads to a structural market underproduction of new knowledge. A tax expenditure can reduce the cost of R&D thereby ameliorating the market failure and increasing production (see discussion from McDonnell). Other examples of economic activities with positive externalities and structural underproduction include investments in human capital and in environmental services.

However, tax expenditures generally represent poor policy as they will violate one or all of our tax design principles. They are non-transparent, almost by definition violate the horizontal and vertical equity principles, and they generally disproportionately benefit better off households. They also tend to be characterised by deadweight meaning that they are inefficiently subsidising economic activity that would have happened anyway. In addition, because they distort incentives they lead to suboptimal production, consumption and investment decisions. Finally, because tax expenditures narrow the tax base they require us to set average tax rates higher for households that don't benefit from the tax break. Overall, the elimination of tax expenditures from the system offers a strong initial focus for tax policy reform.

Tax expenditures tend to be non-transparent, inefficient, regressive and economically distortive – they are the obvious starting point for tax reform

Different taxes will each have their own economic and distributional effects. Let's start with growth. Most obviously, taxes on labour income and on profits are, all else equal, expected to have more negative impacts on employment and investment than will taxes on consumption or taxes on wealth, residential property or other capital stocks. Ultimately, whether a tax has a negative impact on living standards and well-being will depend on the public spending use to which that revenue is eventually deployed. There is no monotonic relationship between tax-to-output ratios and economic growth and the net impact on growth of income taxes is ambiguous theoretically with estimates suggesting the actual effect is small. Even huge historical shifts in taxes have generally not been accompanied by observable shifts in growth.

On the other hand, a revenue neutral shift towards base broadening (i.e. eliminating tax expenditures and using the additional resources to reduce headline rates) would likely be beneficial to growth. Structure matters. For example, marginal effective tax rates (METRs) for workers with tenuous labour market attachment (e.g. low skilled workers and 2nd earners) should be kept very low so as not to create barriers to employment. Regarding tax type we can improve growth potential by shifting the composition of taxes away from taxes on employment and towards taxes on different forms of wealth and especially taxes on property, land and inheritance. Such taxes are likely to have minimal if any negative impacts on employment or on investment.

Taxes on consumption may have smaller direct negative impacts on long-run growth than taxes on labour and taxes on profits. However, consumption taxes tend to be regressive and are certainly less progressive than other forms of taxation when considered in general terms. Exceptions may exist for taxes on luxury goods and certain non-necessities. Thus, increasing the relative reliance on consumption taxes would have potentially negative distributional consequences.

Even so, consumption taxes can lead to an overall reduction in income inequality and poverty to the extent they contribute to funding social transfers and an enhanced provision of subsidised public services. The Nordic economies all have high taxes on consumption but generally low levels of income inequality and high levels of well-being. The point is that the policy focus should be on improving the growth and redistribution effectiveness of the overall tax and welfare system rather than on the direct effect of individual measures.

In general, the most effective tax levers for reducing income and wealth inequality are progressive taxes on incomes and progressive taxes on wealth. The Republic of Ireland already has a highly progressive income tax system. However, taxes on the different forms of wealth are generally very modest relative to total household wealth suggesting significant scope for increasing taxes in this area. The position is somewhat similar in the United Kingdom.

Tax design and tax reform must also be compatible with multi-dimensional sustainability considerations. In addition to sustainability issues around longer-term revenue sufficiency we must also consider sustainability over the economic cycle. This means avoiding an over-reliance on cyclically volatile tax receipts such as stamp duty or corporation tax and avoiding long-term commitments based on the continuation of excess or potentially unsustainable receipts.

The most important sustainability dimension of all relates to climate change and biodiversity loss. Tax policy is just one of many available policy levers available, with the carrots of public investment and public subsidies perhaps most fundamental to successful climate action. Nevertheless, it is crucial that greenhouse gases and toxic materials are appropriately taxed in order to fully internalise their negative externalities. Existing fossil fuel subsidies In the Republic (tax reliefs) are worth billions and are particularly egregious from a climate perspective. Even so, their phase out will need to be accompanied by measures to protect lower income households. There also needs to be greater consideration of carefully designed tax reliefs for green investment, for green land use change and for green R&D.

There are many other aspects of reform and policy questions that go beyond the possible scope of this piece. For example, what types of activities should we not tax? Activities that increase human capital might be a good example. Another important question is the extent to which tax powers should be devolved to local and regional levels and, relatedly, which taxes are most appropriate to devolve to local decision makers. The Republic of Ireland and the UK are both chronically centralised relative to other European countries. This may have a negative impact on the quality of economic policy decisions and public spending choices impacting on local areas outside the political centre.

To what extent should tax policy be motivated by international tax justice perspectives? This issue is particularly salient with regards to corporation tax and the potential for undercutting or a 'race to the bottom', but also speaks to the facilitation of aggressive tax avoidance or evasion by high income households. Finally, which taxes, if any, might make sense at a European, EU or even UN level? Certain taxes such as net wealth taxes or taxes on air transport might be difficult to implement effectively at national level and may be more suitably implemented at transnational levels.

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The Irish welfare state is a mongrel system. It uses a mix of means-tested, insurance based and universalist income support and service arrangements. The pension system is the most expensive component of the €24.6 billion of social protection spending in 2022 at a cost of €8.3 billion. Other large payments include Child Benefit at €2.3 billion, Disability payments at €2 billion, Jobseeker's Allowance at €1.6 billion and Carer's allowance at €1 billion. The scale of working age income supports tends to be the most volatile from year-to-year as it depends on the underlying performance of the economy and the unemployment rate.

What is the core purpose of the system of income supports and subsidised public services? We can describe a welfare system as succeeding or failing to the extent individuals and households do, or do not, have incomes adequate to their basic needs. The enforced deprivation rate can be understood as a proxy for income inadequacy and therefore as a measure of policy failure in protecting households and as a way of identifying which groups are being failed.

Deprivation arises from the mismatch between incomes and the cost of living. Governments can choose to reduce the cost of living via the provision of subsidised universal basic services (UBS), including housing. UBS is discussed in more depth in an earlier NERI long-read (here) and is central to the adequacy debate. A greater emphasis on universal basic or universal public services will structurally reduce the overall cost of living for households. This is ultimately positive for competitiveness and for living standards.

No welfare system has ever achieved a deprivation rate of zero. The proportion of people living in enforced deprivation in the Republic increased from 13.8% in 2021 to 17.7% in 2022. Deprivation rates vary significantly by age. Children have a one in five probability of deprivation (19.9%), whereas it is less than one in eight for retired people (12.0%). Certain cohorts are particularly vulnerable. Persons living in one-adult households with children under 18 have a 43.5% probability of deprivation; persons unable to work due to a disability have a 44.4% probability, while renters have a 35.6% probability.

Discussions about income sufficiency and poverty reduction need to be evidence based and transparent. What we ultimately need is a regular benchmarking exercise to determine adequacy in respect of all working-age and other income supports including supports for the unemployed, people experiencing disabilities, pensioners, and people parenting alone. Benchmarking has been proposed by a range of institutions and bodies including NERI, the ESRI, the COTW, the Pensions Commission and many others. Ideally, an on-going evidence-led process with sufficient resources provided to an independent advisory body would feed into the annual budgetary process with the recommendations and methodologies underpinning multi-annual targets made public months in advance of the budget.

What should payments be benchmarked against? There are a number of plausible benchmarks. These include A) the median wage, B) the median income, C) consumer price inflation or the personal consumption deflator, or even D) a derived indicator linked to an individual or household's minimum essential standard of living (MESL). A composite indicator could also be considered. The value of the income support would be set at a percentage or narrow range of percentages against the benchmark.

As it happens, benchmarking to price alone is unsuitable because it would mean that income supports fall increasingly below wages over time and that living standards for those dependent on working age or old age supports would increasingly fall behind the rest of society. On the other hand, benchmarking against wages has a number of advantages. In particular, it ensures that rates are set cognisant of employment impacts. The main argument for using the MESL as a benchmark is that it is cost of living rather than wages that determine an adequate income and the logic goes that only the cost of living can be an appropriate benchmark for adequacy.

There are other important questions. How best to cater for household composition and household economies of scale? Assessment of adequacy thresholds will require data regarding cost of living and household consumption for different cohorts. Whether benchmarking should be backward looking or forward looking is another important question. A backward-looking process may not be suitable in a period of volatile inflation, whereas forward looking projections are invariably somewhat inaccurate.

There are additional welfare reforms needed beyond that of benchmarking. Implementation of the COTW's proposals for a new and tapered working age assistance payment available to all households and the COTW's proposal for an additional tier of income tapered child income support would be extremely welcome. In particular, the ESRI found that a 2nd tier of child benefit could reduce child poverty by a quarter. Moving to a tapered 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 by ensuring that METRs remain low while simultaneously targeting income inadequacy.

The welfare system also needs to be reformed to make it simpler and more coherent. In particular, policymakers should eliminate all cliff-edges and step-effects from the system. Crucially, the entire welfare system including secondary benefits should be designed on a cross-departmental basis in order to ensure the overall system is coherent and integrated with appropriate and necessary data gathering and analysis. A single department should hold ultimate decision-making power over design issues with other departments operating in an advisory capacity.

The Irish government's responses to the pandemic and to the cost of living crisis were revealing in terms of the ad hoc nature of policymaking. The government correctly responded to the 2020-21 pandemic shutdown of the economy via schemes that maintained links to employment and by temporarily protecting households that experienced an income loss. This was an appropriate and necessary once-off response to a temporary shock.

However, the government then proceeded to respond to a price inflation shock with a menu of temporary supports in 2022-23. Many of the supports given were universal in nature despite the fact that the household savings rate was very high and that there was record levels of net household wealth. The response betrayed a fundamental lack of understanding of inflation dynamics. Once the temporary supports are removed the more vulnerable households will still be confronting higher prices and will be at increased risk of deprivation. The flawed policy response exemplified the need for a multi-annual evidence-based approach to dealing with adequacy issues. If a benchmarking process was in place it would have been possible to make much better informed and targeted policy decisions.

Finally, the issue of adequacy goes well beyond consideration of welfare rates. A future long-read will examine the role of adequate wages in this debate.

The welfare system needs reform – we need to transition to a simpler evidence-based benchmarking process

The pandemic and pandemic response brought the issue of security and social insurance back to the fore. A more permanent expansion of social insurance benefits that links benefits to contributions has been long overdue and needs to encompass unemployment, illness and inability to work, maternity and paternity. Social insurance is much less developed in the Republic of Ireland (and in the UK) relative to most of Western Europe. Net replacement ratios are well below peer country norms. A sudden fall in income can put immense strain on household finances.

Income related social insurance provides a form of security that enables people to be less risk averse as they will be able to maintain living standards when temporarily out of work. Lower risk aversion can have a significantly positive effect by pushing people to search for newer and better jobs. This reduces over-qualification and ensures better job matching and better utilisation of human capital.

Income related social insurance will also assist in the just transition by protecting workers in declining 'brown' sectors from loss of income as the economy transitions to net zero emissions. In addition, income related social insurance dampens the amplitude of recessions via consumption smoothing. Pay related unemployment benefits act as 'automatic stabilisers' that help preserve aggregate demand and therefore protect other people's jobs during a downturn.

Social insurance contributions would need to increase over time in order to pay for the enhanced benefits. NERI research has repeatedly shown that the Republic of Ireland is out of line with Western European norms when It comes to social contributions. The main explanation Is the very low level of employer contributions. These amounted to just 4.4% of GNI* in 2019 compared to 8.2% of GDP in the EU. In other words, employers are contributing just half of what their peers contribute on average. As a consequence, income protection for workers is very weak by EU standards. More positively, it suggests ample scope to increase revenues in order to fund enhanced benefits.

An expansion of pay related social Insurance benefits is long overdue

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Our tax and welfare systems will need to reform in order to meet the challenges of the 21st century. Upcoming megatrends will put increasing pressure on the public finances to the extent that government revenue will need to meaningfully increase its revenue as a percentage of national income.

In this context we need to consider how best to increase revenue in a manner consistent with on-going improvements in living standards. Four broad sources of potential revenue variously present themselves as good candidates. The sources are A) reducing the availability and the generosity of tax expenditures; B) increasing taxes on sources of wealth including property, land and inheritances, C) increasing taxes on pollution including greenhouse gas emissions and D) increasing PRSI contributions to fund enhanced social insurance benefits particularly employer contributions.

The welfare system also needs reform. In particular, all social protection rates should be integrated into a coherent benchmarking process that ensures adequacy for all households. Finally, the social insurance system needs to be enhanced and reformed in order that we can properly meet the just transition challenges and disruptions of the 21st century in a way that ensures security for all.

Our tax and welfare systems will need to reform in order to meet the challenges of the 21st century

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