Response to invitation from Select Committee on Budgetary Oversight to make a written submission on Chapters 9, 10, 11 and 12 of the Report of the Commission on Taxation and Welfare (COTW)

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1. Introduction

In my response I will group Chapters 10, 11 and 12 together as these Chapters form the bulk of the welfare recommendations in the Commission on Taxation and Welfare (COTW) report. I will conclude with some observations about Chapter 9. The NERI is broadly supportive of the recommendations and the overall analysis and strategy in Chapters 10, 11 and 12 but has some significant concerns about aspects of Chapter 9.

NERI would be delighted to engage with the Committee on any of the issues raised in these chapters or indeed any other chapters of the COTW report

2. Welfare Recommendations (Chapters 10, 11 and 12)

2.1 Context

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

Fiscal sustainability concerns, and the view that tax and welfare are actually a single system, underpin NERI's view and the view of the COTW in terms of the preferred approach to tackling welfare reform. It is unfortunate that discussion of the provision of subsidised or free public services, i.e. the third leg of the stool in terms of income adequacy, was outside the scope of the COTW's terms of reference.

The Irish welfare state is a hybrid or 'mongrel' system. It uses a mix of means-tested, insurance based and universalist income support and service arrangements. Spending on social protection according to the Department’s Annual Statistics Report was €30.4 billion in 2021 (7.1% of GDP). This included €8.8 billion on Covid-19 supports. There were 2.03 million recipients and 3.32 million beneficiaries. The largest area of spending in most years is pensions (688,000 people and €8.9 billion in 2021). Spending on illness, disability and carers (431,000 people and €4.8 billion) and on child related benefits (€2.6 billion) also make up large components of spending. The scale of working age income supports is more volatile from year-to-year as it depends on the underlying performance of the economy and the unemployment rate. These supports cost €7.2 billion in 2021 (inflated by the pandemic) but were just €3.3 billion in 2019.

It is important to consider how well our system of income supports and subsidised public services is performing in its job of protecting households from income inadequacy. The enforced deprivation rate can be considered a useful proxy for income inadequacy. No welfare state has ever achieved a deprivation rate of zero. Even so, we can think of the deprivation rate as a measure of the failure of the welfare state to protect households.

The proportion of people living in enforced deprivation increased from 13.8% in 2021 to 17.1% in 2022. Deprivation rates vary significantly by age. 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 to enforced deprivation. 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. We anticipate that the surge in the consumer price index in 2022-23 and the decision not to index welfare rates in Budget 2023 will lead the deprivation rate to increase in 2023.

2.2 Overarching goals

The COTW identified a set of sometimes conflicting core principles for taxation and welfare policy – sustainability, reciprocity, adequacy, equity and efficiency. The adequacy principle is particularly central to the discussion of income sufficiency and poverty reduction. Other key policy considerations relevant to welfare reform include the potential impact on labour force participation, the need to avoid discontinuities in the tax and welfare system, the new administrative opportunities afforded by technological change and the provision of subsidised public services.

The key recommendations on adequacy are set out in chapter 12. The recommendations argue for:

- Regular evidence based benchmarking exercises for working age payments. This complements the Pension Commission recommendation in relation to pension adequacy.
- Multi-annual targets for payment rates to progress towards the benchmark.
- Reform of working age payments to ensure an integrated and coordinated system based on adequacy and the removal of cliff edges in the tax and welfare system.
- A new working age payment that is tapered by income.
- A second level of child income support that is tapered by income.

The NERI welcomes each of these recommendations.

2.3 Chapter 10 recommendations: Labour market and social protection systems

Chapter 10 made a number of recommendations that would, if enacted, broaden the base of PRSI consistent with the principles of reciprocity, horizontal equity and fiscal sustainability. In particular, the COTW recommends A) Introducing a lower nominal rate of employee PRSI applying to earnings below the PRSI contribution threshold of €352 per week; B) Extending PRSI to all sources of employment income including share-based remuneration; C) Extending PRSI to those over the State pension age on all income other than social welfare payments; D) Removing the PRSI exemption on supplementary pension income; and E) Keeping PRSI on unearned income aligned to the higher rate of PRSI applicable to employees on their income from employment.

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. However, we understand that this recommendation should be considered alongside the new enhanced working age payment the COTW is also recommending as well as the recommendation that working-age income supports be benchmarked adequately against an appropriate index. If implemented together, the cumulative effect of the proposals would be to enhance income adequacy for vulnerable households. It should also be noted that the COTW is recommending the low entry rate for access to social insurance be maintained. This is welcome.

Another important recommendation in Chapter 10 is 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 for a benefit and the generosity of the benefit should taper down as the person's income increases. This is an extremely important and welcome recommendation.

Finally, the COTW did not support the introduction of a Universal Basic Income (UBI) in Ireland. Instead, the COTW is recommending a regular (ideally annual) and evidence based benchmarking exercise. There are a wide range of arguments both for and against the introduction of a UBI, all of which we are happy to discuss at length if desired by the Select Committee, but the crucial arguments against its recommendation are the significant deadweight of UBI as an anti-poverty measure and the profound implications for taxes and for other areas of public spending (both services and income supports) given the enormous fiscal cost attached to a meaningful UBI.

2.4 Chapter 11 recommendations: Promoting employment

One of the main concerns underpinning Chapter 11 was the need for a coordinating agency within government that was responsible for A) ensuring policy coherence, B) the minimisation of negative incentives, and C) effective targeting. This inevitably lead to the recommendation that the Department of Social Protection should be closely involved in cross-departmental ex ante analysis and in the design of any potential new scheme before it is introduced. This necessary to ensure appropriate integration and tapering of secondary benefits with the existing framework of income supports. Unfortunately, this does not appear to be happening at the moment leading to sub-optimal policy choices and design.

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 minimised or eliminated for tax purposes. While it was historically the case that the self-employed only benefited from a narrow range of contributory benefits this is no longer the case and therefore the justification for a lower rate is no longer valid.

The transition from the lower rate of employer PRSI to the higher rate triggers particularly high marginal rates within a narrow range of earnings. This creates a disincentive to employ someone to work additional hours. NERI therefore strongly supports the COTW recommendation that only one rate of employer PRSI (the higher rate) should apply on all weekly incomes. The lower rate should be phased out.

We also agree that the USC surcharge on non-PAYE income above €100,000 does not comply with the principle of horizontal equity. However, this does not imply that the surcharge should be removed and the COTW report does not make this recommendation. The horizontal equity concern could be resolved by A) removing the surcharge; B) extending the surcharge to all income over €100,000, or C) applying a blended rate on a revenue neutral basis.

In a similar fashion, we agree that there should be a move towards individualisation of the standard rate cut-off (SRCO) point. This would facilitate increased employment and potentially decrease the employment rate between women and men. However, individualisation can be achieved by A) increasing the SRCO point for single people, B) reducing the SRCO point for married couples, or C) applying a blended threshold on a revenue neutral basis. Option B would be most consistent with the COTW's main recommendation that Ireland's revenue yield will need to increase materially over time.

2.5 Chapter 12 recommendations: Inclusive and integrated social protection

This is the chapter with the bulk of the main welfare reforms and the NERI supports the overall recommended approach that would see Ireland move to a multi-annual, transparent and evidence based approach.

2.5.1 Benchmarking

The NERI strongly supports the recommendation that government should 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 an extremely 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.

Our view is that benchmarking should become an ongoing transparent and evidence-led process with sufficient resources provided to an independent advisory body or 'benchmarking commission' similar to the Low Pay Commission or the Fiscal Advisory Council. This process would involve the setting of multi-annual targets for social welfare rates in order to provide for regular incremental progress.

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 benchmarking commission that would adjust benchmarks over time based on emerging evidence and practical experience. Such a body could be set up by government but also independent of government, similar to the Low Pay Commission or the Fiscal Advisory Council.

2. What should we benchmark payments against?

There are a number of plausible benchmarks. These include A) the median wage, B) the median income, C) price inflation (e.g. CPI, HICP 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 benchmark based on a dashboard of indicators could also be considered. The value of the income support would be set at a percentage or narrow range of percentages against the benchmark.

Benchmarking to price is unsuitable because it would mean that income supports fall increasingly further behind average wages over time and living standards for those dependent on working age or old age supports would increasingly fall behind the rest of society. This is because wages tend to outstrip prices in most years.[1] While it is true that price growth is going to outstrip average wage growth in 2022 and 2023 this should be understood as exceptional and the consequence of an exogenous and ongoing energy supply shock.

Benchmarking to the median wage has a number of advantages. In particular, it ensures that rates are set cognisant of potential employment impacts. The national minimum wage is already set to be benchmarked to the median wage and benchmarking income supports against the median wage would therefore ensure a degree of policy coherence. The main argument for using an MESL metric as the 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.

A related issue is whether policymakers should aim for a defined percentage of the benchmark or, alternatively, whether it is reasonable to oscillate within a narrow percentage range against the benchmark. A narrow range is likely to be more feasible from a practical perspective and it gives policymakers a degree of policy discretion.

[1] A simplified equation for long-run average wage growth in most countries is 'price inflation + productivity growth'.

A benchmarking commission would also need to consider how best to cater for household composition including additional payments for dependent adults and children. How should policymakers account for economies of scale? Assessment of adequacy thresholds will require data regarding cost of living and household consumption patterns for different cohorts. This will allow different rates to be calibrated to reflect circumstances such as cost of disability, cost of renting, and cost of parenting alone.

3. Should the benchmarking process be forward looking or backward looking?

Benchmarking is likely to be done against some annual average for a particular indicator such as median wages or price inflation. However, forward looking wage and price projections are invariably somewhat inaccurate. A forward looking approach is therefore more consistent with a ranged benchmark approach and to focus on making annual progress towards a multi-annual goal. Projecting averages over multiple years (three to five) and then proceeding on a rolling annual basis would be preferable to benchmarking against one year projections. Some degree of year-to-year oscillation around the benchmark would be inevitable. On the other hand, a backward looking approach may not be suitable in a period of volatile inflation where living standards can be quickly eroded. There would need to be an update of the multi-annual targets at least once a year.

2.5.2 New Working Age Assistance Payments

The NERI welcomes the recommendation that there be a new and tapered working age assistance payment available to all households including those without children. This is essentially a reform of the working family payment and jobseekers allowance. 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 a crucial element of this as it ensures that marginal effective tax rates remain low.

Overall, the COTW's proposed structure is very well targeted at reducing poverty while simultaneously helping to minimise employment disincentives.

2.5.3 Child income supports

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

It is income that matters for adequacy not whether somebody is on one side or another of some arbitrary threshold. Crucially, the proposed supplement would not depend on employment status but only on income. Effectively, households on social welfare would automatically receive a 100% support that would replace the current qualified child payments while working low-income households would receive the tapered in work support. This again combines maximum targeting with a minimisation of employment disincentives.

2.5.4 Pay related benefits

The COTW is somewhat lukewarm as to the case for pay related benefits and instead focuses on design principles in the event that policymakers decide to proceed with pay related benefits. The COTW argues that pay related benefits: A) should be for a limited time (shorter than the duration for jobseekers benefit), B) should occur in tandem with reforms to the sustainability of the social insurance fund (implying a need for increases to the PRSI yield), C) and should be subject to an earnings cap. The COTW notes there is a case for linking other benefits to previous earnings including maternity benefit and illness benefit.

The NERI view is that the case for income related social insurance is actually stronger than that outlined by the COTW. Income related social insurance provides a form of security that enables people to be less risk averse because they will still be able to maintain their livings standards when temporarily out of work. The reduction in risk aversion can have a significantly positive effect by pushing people towards newer and better jobs. This reduces over-qualification and ensures better job matching and better utilisation of human capital. The reduction in 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.

Finally, 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 as a whole. The reason Ireland is a low revenue country is that Irish employer social contributions are very low (4.4% of GNI* compared to 8.2% of GDP in the EU). In other words, Irish employers are contributing just 53% of what their peers in the EU are contributing on average. The implicit (effective) tax rate on employer contributions is 9.2% in Ireland and 17% in the EU as a whole. As a consequence, income protection for workers in Ireland is very weak by EU standards.

3. 'Promoting Enterprise' Recommendations (Chapter 9)

While the NERI is supportive of many of the stated aims of this Chapter, such as the need to incentivise R&D and the need to assist SMEs in retaining human capital, there are also many aspects which we find problematic. This includes the COTW's endorsement of a range of tax expenditures.

The other seventeen chapters make consistent acknowledgement of the need to minimise tax expenditures and differential tax treatment. The position taken in the other chapters 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. Consequently, in these other chapters the recommendations emphasise restricting and removing the use of such hidden subsidies and distortions.

In our view, this approach is correct and is justified on the grounds of horizontal equity, vertical equity, economic efficiency and transparency. I noted in Annex 3 of the COTW report that 'if there is an intellectual theme to the Report it is that the tax base should be broadened and tax expenditures eliminated.' However, this approach is effectively set-aside in chapter nine.

Chapter nine contains a series of recommendations that endorse and support 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, they also breach the principles of vertical and horizontal equity, are highly regressive, reduce transparency, and are at odds with tax justice and solidarity principles. Individually they are problematic, albeit perhaps, in some cases, defensible. Collectively they undermine the approach taken in the rest of the COTW report.

I will give just one example to explain what I mean. The COTW recommends restricting the Special Assignee Relief Programme (SARP) rather than scrapping it completely. SARP effectively demolishes the principle of vertical equity. It allows people with extremely high income to have an income tax rate of 28% while a second person earning a close to average salary has an income tax rate of 40%. The COTW report notes that 50 claimants had income of between €1 million and €3 million in 2019 and were able to reduce their income tax by €111,000 on average. SARP also allows for private school expenses to be exempted from tax. This particular provision makes a mockery of the notion that Ireland is a land of equal opportunity.

SARP and measures like it 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 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.