Indexation of the Taxation and Social Protection System

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NERI Comments to the Select Committee on Budgetary Oversight

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I thank the Cathaoirleach and the Select Committee for the opportunity to discuss potential indexation of the taxation and social protection system.

Rationale for Indexation

The principal rationale for *price indexation* is to offset the effect of cost of living increases on quality of life, poverty and deprivation.

Benchmarking the various welfare rates to some defined measure of sufficiency is an important *complement* to indexation. We need to know whether we are currently achieving our poverty reduction targets.

As such, price indexation is merely a proxy for a 'stand-still' policy. It might keep living standards at their current levels, but it will not improve them.

Inflation rates such as the CPI may actually under estimate cost of living increases for lower income households. For example, the current high level of inflation is concentrated in areas like energy, housing and food that disproportionately affect lower income households.

The principal rationale for *wage indexation* is that it broadly prevents a worsening of income inequality. Crucially, wages generally rise faster than prices, so that wage indexation will tend to improve living standards for poorer households over the longer-term.

The main negative consequence of indexation is the fiscal cost. Indexation reduces scope for policy innovation and spending in other areas. The annual fiscal space for net growth of expenditure is linked to the economy's medium-term potential growth rate. Cost of living issues can be addressed in other ways.

It should be noted that indexation of tax and welfare would also need to be accompanied by proportional uplifts to legal wage minima, such as the national minimum wage, as well as to the income thresholds for benefits. Doing so avoids the potential for labour market distortions that may arise.

Creation of an indexation system

The NERI would propose *wage indexation* as the more appropriate baseline. This could then be supplemented with a system of modest and defined annual adjustments that gradually move the individual rates towards an empirically based and politically agreed benchmark for sufficiency that is based on the cost of living for various cohorts. The growth in average weekly earnings is preferable to the growth in average hourly earnings as it is weekly earnings that determine living standards.

If on the other hand we replace our current ad hoc system with price indexation, then income inequality will rise over time as welfare benefits fail to keep pace with labour income and capital income.

However, we are not convinced that a triple lock based on some arbitrary minimum is a particularly good idea. While the triple lock is an effective indexation link for maintaining and improving living standards, it is also the most costly to the exchequer, limits policy flexibility, and could cause economic distortions if it were to consistently grow faster than wages.

All social protection payments as well as thresholds for access to certain payments, including non-cash benefits, should be given equivalent treatment. Indexation should apply to all payments if it is to apply to any payments.

Similarly, were indexation to be applied it should also then be applied equally across all taxes on labour, notwithstanding the need to review the tax system on an ongoing basis against the core principals of fiscal sustainability, economic efficiency and equity.

Again, the issue of sufficiency benchmarking is relevant. Indexing should not replace the ongoing annual process of reviewing the tax and welfare system.

Excise duties such as those on alcohol, cigarettes and carbon would ideally be incorporated into any indexation system. However, price inflation rather than wage inflation is the appropriate baseline for indexing excise taxes as they are taxed per commodity unit rather than on a percentage basis. If they are not indexed to price then they will gradually become cheaper relative to other goods. On the other hand, if they are indexed to wages they will gradually become more expensive relative to other goods.

Operation of indexation

The economy is a complex and dynamic system with many moving parts. Projecting often volatile wage and price trends is fraught with difficulty. This is particularly the case for short-to-medium term forecasting over a six to eighteen month time horizon. We are going through a period of high price volatility on account of a truncated economic cycle.

Wage inflation can also be highly volatile. Weekly earnings grew sharply in 2020 due to the compositional skew of jobs lost during the early period of the pandemic.

Indexing to some assumed price or wage trajectory is therefore problematic, although there are a number of potential workarounds.

One way to design indexation may be to make it backward looking rather than forward looking. This connects the increase in welfare rates and tax bands to actual developments in the economy.

Weekly wage growth averaged over the four most recent quarters of annual growth could be one of many plausible options. A smoother pattern of growth over time would be generated by including more quarters of data.

Alternatively, indexation could be set at a presumed long-run average for wage growth, with this value re-estimated every few years. This would add certainty to household budgeting as well as to the public finances.

Sharp increases in inflation would remain a potential problem but this is equally true of our current ad hoc system. It’s not realistic or desirable to expect an annual budget to be completely flexible and responsive to short term price swings. Policy stability is important to the perception of the public finances, and revaluations should only be triggered in extreme circumstances. In any event, the assumption is that sharp and sustained price increases would eventually be reflected in higher wage growth and therefore in the following year’s indexation.

Inflationary pressures in particular areas such as energy costs or housing costs could in theory be addressed via changes to the relevant secondary welfare payments, or benefit threshold. However, this should only trigger in extreme cases. Recall that indexation based on wages will exceed CPI inflation in most years.

Impact of indexation on sustainability

The NERI anticipates long-run price inflation of close to 2% and long-run wage inflation of close to 3.5%. Extrapolating from ESRI estimates for Budget 2020 conducted by Tim Callan, Claire Keane and Mark Regan, and working on a static pre-pandemic basis for total unemployment, suggests that price indexation at an average of 2% would cost close to €750 million of fiscal space per annum and that wage indexation of 3.5% would cost in the region of €1.3 billion.

The Irish Fiscal Advisory Council's fiscal space calculator indicates that a 1% wage increase raises €181 million from not indexing the tax system.

Annual price inflation has averaged 1% over the last three years while weekly wage growth has averaged close to 4.5% per annum.

Indexation in line with wage earnings is sustainable in terms of fiscal space and is fiscally neutral. It does reduce policy flexibility, but also adds to certainty for household budgeting, and arguably adds to fairness and fiscal certainty as more politically powerful cohorts will have less opportunity to push for special treatment at pre-election budgets.

Thank you and I look forward to the engagement.

Ends