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"Some Reflections on the Commission on Taxation Report 2009"

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Some Reflections on the Commission on Taxation Report 2009

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1 Introduction

Overall, this is an excellent report, which seeks to relate its findings to the underlying evidence whenever possible. While there is certainly room for debate about the terms of reference given to the Commission, the Report certainly provides a comprehensive treatment of those tax issues that did fall within its remit. The general analytical framework that it adopts adheres to the cutting edge of the public finance research literature. In particular, there is full recognition that Ireland is a highly-globalised economy and faces intense competition for internationally-mobile resources, such as (physical or knowledge) capital and high-skilled labour.

Its primary focus is on the 'steady-state' properties of the tax system, which is a natural approach in view of the long time gap between this report and the reports in the early 1980s from the previous Commission on Taxation. The recommendations of the Report identify the principles for a more efficient and fairer tax system. However, in a number of cases, follow-up research will be required in order to convert 'recommendations in principle' into detailed implementation plans.

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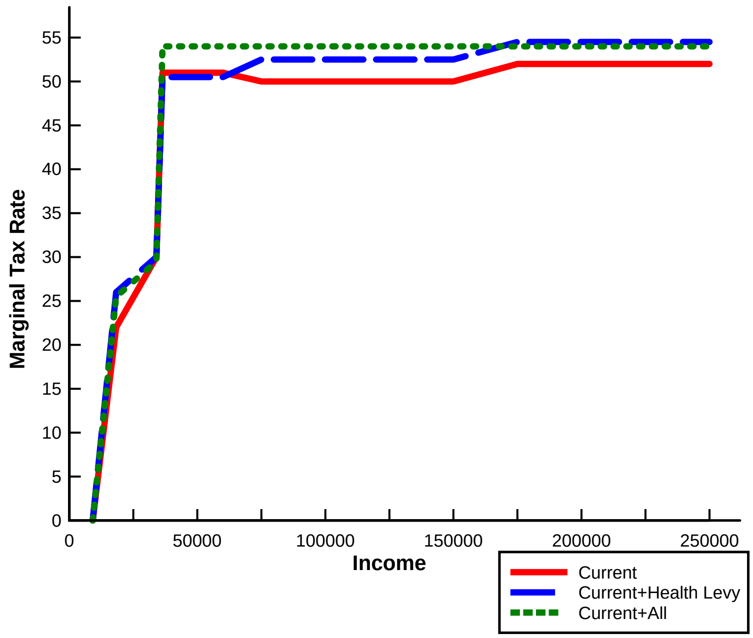

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Figure 1: Marginal Tax Rate (Employees). Source: *Commission on Taxation Report 2009.*

Given the limited time available, I will take a very selective approach to discussing the 2009 report of the Commission on Taxation. In particular, I will focus on: (a) the labour market; (b) retirement savings; and (c) taxation and the economic cycle. Finally, I will turn to some implementation issues in the the final part of this discussion.

2 Labour Market

In its treatment of income taxes, the Commission highlights the importance of preserving the incentives to work for those on low earnings. In particular, an important recommendation is to exclude those on the minimum wage from the income tax net. In addition, the Commission also underlines the adverse impact of high average and marginal tax rates on the location decisions of internationally-mobile workers, with attendant knock-on effects on the location decisions of those enterprises that seek to employ high-skilled workers.

The desire to keep the labour tax burden as low as is feasible motivates many of the findings in the report. In particular, the scale of labour taxes is inversely related to the width of the general tax base. Accordingly, the introduction of an annual property tax, carbon tax and the extension of other forms of non-labour taxation are required in order to relieve pressure on labour taxes.

While such innovations are certainly important, it remains the case that labour taxes will always be a major revenue source. Accordingly, the efficient and fair design of the labour tax system is a major priority and the Commission devotes a lot of attention to this issue. One important feature is that taxpayers enter the highest tax band at a relatively low level of earnings (see Figure 1). With the major increase in the top marginal tax rate over the last year (taking into account PRSI, the income levies and increase in the health levy), this represents a more serious problem than during the boom years. Moreover, the effective marginal tax rate on higher earners is set to remain at an elevated level even if the temporary income levies are abolished in view of the recently-agreed abolition of the ceiling on employee PRSI contributions.

One element in moving individuals out of the top tax band is to review the levels of tax credits, allowances and reliefs. In addition, the Commission on Taxation has recommended that a three-band income tax system be examined: while this in itself will not collect more revenue, it provides more options in terms of the balance between efficiency and equity. An important near-term priority for further research will be to examine the costs and benefits of alternative three-band systems.

3 Retirement Savings

The section of the report that deals with saving for retirement (whether through traditional pension products or long-term savings schemes) is clearly influenced by the latest thinking in behaviourial economics. This vibrant area of research has highlighted the importance of dealing with pyschological factors in encouraging a long-term approach to saving for retirement. In addition, behaviourial economics emphasises the importance of simplicity in designing pension and savings schemes.

Building on such insights, the Commission has highlighted the potential gains to adopting a "soft mandatory" approach to pension provision, where the default is that each worker is enrolled in a pension plan but with an "opt out" clause. By changing the default position, this approach encourages wider participation in pension schemes by combating the forces of inertia and myopia that may deter individuals from taking pro-active steps to secure pension arrangements.

The Commission has also recommended the introduction of a SSIA-type long-term savings plan for low earners that may not be willing to sign up for a regular pension plan. Such a SSIA plan would allow for some draw-down of savings before retirement, such that the participants may be reassured that a buffer stock of savings will be available.

Consistent with the behaviourial economics approach, the Commission recommends that State subsidies for retirement savings should take the form of matching contributions (whether to regular pension plans or the SSIA-type savings plan). This may be more tangible to many participants than tax reliefs, as well as being available to those that fall outside the income tax net. The Commission recommends a common level of matching contribution to all participants. The recently-agreed common rate of 30 percent tax relief on pension contributions may be interpreted as an intermediate step towards this goal.

An intriguing feature is that Commission suggests that the NTMA could have a role in providing a low-cost savings plan for participants. This begs the question of whether the NTMA could have a broader role in providing low-cost pensions plans on a broader basis. This would tackle a major problem in the current pensions system: the relatively high administration and management costs in operating a large number of relatively-small pension funds. In contrast, the operating costs for the National Pensions Reserve Fund (expressed as a percentage of total assets) are extremely low.

4 Taxation and the Economic Cycle

The report has a very interesting section that addresses the role of taxation policy in stabilising the economic cycle. The Commission seeks to contribute to greater economic stability through a broadening of the tax base. For instance, an annual property tax should be more stable than transactions-based taxes such as stamp duty. However, the report goes further by recommending changes in how budgetary policy is made.

First, it recommends that the fiscal process makes a stronger distinction between the structural and cyclical components in the budget balance. This will help avoid procyclicality in fiscal policy by underlining the transitory nature of cyclically-induced fluctuations in tax revenue. An important suggestion is that the measurement of the structural balance might be delegated to an independent agency (such as the ESRI) in order to depoliticise the analytical element in determining the appropriate cyclical stance for fiscal policy.

Second, the report also recognises that there may be a case for cyclical variation in some tax instruments in order to "lean against the wind" in the event of a bubble emerging in the housing market. More generally, fiscal policy is the main macroeconomic policy instrument available to a member country of a monetary union and the report recommends further research on the appropriate role of fiscal policy in supporting greater economic stability. In view of the current fiscal crisis, this is an important area for reform that should be pursued.

5 Implementation Issues

While the short-term issues that have been thrown up by the current crisis may lead to a temptation to defer full consideration of the report, this would not be an optimal strategy. In particular, a major concern for many investors and international analysts is the potential adverse impact of the current crisis on Ireland's long-term growth potential. Since the distorting costs of an inefficient tax system are increasing in the overall level of taxation, it is even more important to address tax reform now than in the pre-crisis period when the report was initially commissioned. By drawing up a detailed and credible implementation plan, the government can contribute to a faster pace of economic recovery by reassuring firms, households and investors that the inevitably-higher tax burden that Ireland now faces will be distributed in an efficient and equitable manner.

As is fully recognised in the report, such an implementation plan does not imply that the full report should be implemented overnight. Rather, a multi-year transition period will be required. Moreover, a number of recommendations do require further analysis in order to convert the principles outlined in the report into a detailed action plan. These factors reinforce the importance of getting an early start in converting the report into action. The high level of uncertainty about the future prospects for the Irish economy means that there would be an immediate payoff in demonstrating commitment to significant tax reform.