Future Fiscal Options are Taxing: The ESRI Report

by Jim Power

Prior to Covid-19 the Irish public finances were in a vulnerable place, with the debt to GDP ratio at 57.4 per cent at the end of 2019, and more importantly, the debt to GNI* (Modified Gross National Income – which is a more representative representation of what is really happening in the domestic economy) at 95 per cent. Thanks to the pandemic, the debt to GDP ratio had jumped to 59.5 per cent of GDP by the end of 2020, and debt to GNI* stood at a dangerously high 105 per cent.

Despite what some have claimed over the past couple of years, debt actually does matter, particularly for a small open economy like Ireland. We saw back in 2010 the consequences of too much debt and the implications when those who buy our debt lose confidence. While international confidence in Ireland is very high at the moment and the National Treasury Management Agency (NTMA) has no problem borrowing at interest rates that are close to historic lows, it would not be sensible to continue to borrow and build up dangerously high level of debt on the basis that interest rates will remain low and international lenders will be prepared to lend without limit to Ireland indefinitely. From my fiscally conservative perspective, that would be a dangerous strategy. At some stage borrowing costs will rise and unfortunately for a small borrowing nation at the whim of international markets, we cannot be guaranteed that we will always be loved by international bond markets. Consequently, it is essential that the gap between revenues and expenditure is narrowed over the coming years. The only question is whether it is done through controlling expenditure (something Irish governments are not particularly good at) or increasing taxation, or more likely a combination of both.

Taxation is always a controversial topic. Those who pay little or no tax generally argue that others should pay more, and those who do pay the bulk of tax generally believe they are paying too much. The balance between the level of Government expenditure and taxation is really what defines the divide between left and right-wing political ideologies. It is very difficult to bring the two sides together.

However, one thing is very clear – an adequate level of tax revenue is necessary to fund vital public services, but those who pay the tax should expect that the monies are spent wisely and that value for money is the guiding principle.

Looking ahead, many pressures will present themselves on the expenditure front. These pressures include necessary climate change mitigation measures, housing and of course demographics and an ageing population which will have profound implications for expenditure on healthcare, care for older people and pensions. An ageing population also has implications for the tax base, which of course could be alleviated by inward migration of younger workers.

In the face of these challenges, it is essential that tax revenues are adequate and that the tax base is as broad as possible. However, it is essential that the burden of taxation does not discourage full labour force participation and entrepreneurial endeavour. At the end of the day, economic growth is essential to generate the tax revenues that will fund public services. If the tax system damages economic activity, then the funding of those services will become much more difficult.

The ESRI has recently argued that future spending pressures combined with potential declines in corporation tax and motor tax receipts, mean that significant future tax increases are likely to be needed in the years ahead. The pressure on corporation tax receipts could emanate from the OECD-driven tax changes, while various motor tax receipts could emanate from the move to lower emission and currently lower taxed electric vehicles, while the move away from diesel and petrol could undermine fuel taxes. However, I am sure that the Revenue Commissioners and the Department of Finance will come up with all sorts of inventive ideas to compensate through other taxes on motoring.

Some of the suggestions posited by the ESRI include increasing the standard and higher rates of income tax by 1 percentage point; raising the standard and reduced rates of VAT by 1 percentage point; or charging the Local Property Tax on up-to-date valuations (that is now happening). It does not believe that a wealth tax is very practical, given that if property was to be exempted, such a tax would raise little revenue unless levied at very high rates. Instead, it suggests a focus on the scope for increasing revenues from transfers of wealth.

The ESRI also discusses the potential for raising revenue by restricting or abolishing tax reliefs which have questionable economic rationale or are poorly targeted at achieving their stated aims. It mentions exempting pension lump-sums of up to €200,000 as being poorly targeted as it mainly benefits high earners and encourages the withdrawals of large lump-sums on retirement. It is

very easy for a public sector body with guaranteed employment and pensions to target private sector pensions.
The reality is that tax incentives are necessary to achieve certain things. If private sector pension provision is totally inadequate, then we will end up with a new species called the 'retiring poor', with serious implications for economic activity and future pressure on State pensions. Tax incentives do encourage private sector pension provision.

The ESRI perspective is very heavily driven by an ideological bent to increase taxes regardless of the economic consequences. Policy makers will need to be very careful about how tax policy is crafted to avoid the law of unintended consequences.

There has been exponential growth in Irish tax revenues over recent years, and this has been driven by economic activity. If we implement tax changes that will dampen economic activity, growth will suffer, with disastrous implications for future tax revenues.

In the first 9 months of 2021 total tax receipts were 15.9 per cent or €6.3 billion higher than the equivalent period of 2020. Income tax receipts were 19.5 per cent higher; corporation tax receipts were 7.9 per cent higher; and VAT was 26 per cent higher.

The strength of tax receipts reflects strong profitability in the multi-national component of the economy; a strong rebound in consumer spending; and the fact that the highest earning and highest tax-paying element of the labour force was not significantly affected by Covid-19. The very progressive nature of the Irish income tax system is ensuring that income tax revenues are remaining buoyant.

The Revenue Commissioners point out that in 2018, around four-fifths of all income tax revenue was paid by the top 25 per cent of income earners, and the top 1 per cent of earners paid over one-fifth of income tax. To me, this represents a classic example of an incredibly progressive income tax system.

Table 1: Annual Tax Revenues

Source: Department of Finance

Irish taxation revenues are dominated by three categories – Income Tax, VAT and Corporation Tax which accounted for almost 85 per cent of total tax revenues in the first nine months of 2021. Income tax accounted for 40.2 per cent, VAT accounted for 27.1 per cent, and corporation tax for 17.6 per cent. It is interesting to note that in 2006, income tax accounted for 27.2 per cent of total tax revenues, VAT accounted for 29.5 per cent and corporation tax accounted for 14.7 per cent.

Despite the pandemic, Irish tax revenues have held up in a remarkable fashion in 2020 and 2021.

The strong performance of multi-national profits is ensuring that corporation tax receipts are also buoyant. A record €11.8 billion was collected in 2020 and a higher level will be achieved in 2021. However, there is a significant concentration risk evident on the corporation tax front. In 2020, the top 10 largest firms accounted for around 52 per cent of all corporate tax revenue. The impending changes to the global corporate tax code will need to be monitored carefully here in Ireland. It would be reckless to continue to allow expenditure rise strongly on the back of a tax base of which some may prove transitory.

Ireland made that mistake with disastrous consequences in the 2000s.

Tax Receipts (Jan-Sep 2021)

Tax Category	€m	% Of Total	Year-On-Year Change
Income Tax	18,445	40.2%	+19.5%
VAT	12,439	27.1%	+26.0%
Corporation Tax	8,057	17.6%	+7.9%
Excise	4,075	8.9%	+7.4%
Stamps	1,144	2.5%	+22.3%
Capital Gains Tax	332	0.7%	+11.2%
Capital Acquisitions Tax	229	0.5%	+19.7%
Customs	355	0.8%	+91.7%
Motor Tax	719	1.6%	-1.8%
Other	70	0.1%	-
Total	45,865	100.0%	+15.9%

Source: Department of Finance

Conclusion

The challenges ahead for Ireland on the tax and expenditure front are significant. It is important to create a tax system that is broadly-based with low marginal rates. It is equally important to exert significant control on all forms of public expenditure, with a much stronger focus on value-for-money than heretofore. Increasing taxes, as the ESRI suggests, is not the panacea for all of our challenges, and could in fact prove totally counter-productive.

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