

Tax and Spend: A Look to the Future with an Eye on the Past

Donal de Buitleir and Pat McArdle
Kenmare Economics Conference, 11 October, 2003.

“The reason to contest the rising tax burden is the Government’s inability to spend the money wisely rather than the overall level of taxation, which is still low by international standards”

- Martin Wolf, Financial Times, 10 April 2003

Introduction

This paper provides estimates of the public finances to 2007 as a backdrop to the development of recommendations for a sustainable and economically appropriate fiscal policy. This is followed by a discussion of some macro policy issues. We then examine whether or not the apparently low tax burden in Ireland suggests that Government spending is inadequate. Finally, we consider some fiscal policy questions for Budget 2004 and future years.

PUBLIC FINANCES

2003 Budget

The 2003 Budget was a difficult proposition in that the opening deficit was almost €5.0 billion. The Government responded by establishing an Independent Estimates Review Committee (The Three Wise Men). Together, the Wise men and the Cabinet trimmed inflated spending demands by €1.7 billion and Budget Day tax increases brought in €1.2 billion. This meant that Exchequer Borrowing was held at €1.9 billion or 1.7% of GNP and the associated General Government Deficit was €0.9 billion or 0.7% of GDP. While we have to have regard to the traditional Exchequer Balance as most of the Budget Day arithmetic is presented on that basis, the primary focus of this paper is on the economically more relevant General Government Deficit (GGD)¹.

An acrimonious political debate quickly developed over the so-called “spending cutbacks” in the 2003 Budget. The reality is that after all the painful pairing back, net voted current spending is still budgeted to rise by 8.3%, a rate of increase that is unsustainably high by reference to growth in GNP and the capacity of the economy to fund it. More damaging was the decision to curtail capital spending, the usual soft target when times are tough. The outcome was a small fall in budgeted spending as compared with the previous year and voted capital spending as a % of GNP fell from 5.3% to 5%.

Taxes were also increased sharply, with Budget Day announcements adding €1.2 billion to the tax burden and boosting projected tax revenue growth in 2003 to 8%, a rate of increase that broadly matched that of current spending but was also inappropriately high. Because it was Government policy to avoid increases in income tax rates, the focus was on measures designed to bring forward cash flow to the Exchequer (CGT payment acceleration €250 million), some more² once off or temporary measures (Capital Services Redemption a/c €250 million, banks levy €100 million), an effective increase in income tax through non-indexation of bands (€150 million) and, residually, on higher indirect taxes (€770 million).

¹ The original Maastricht conditions for EMU membership and the ongoing Stability and Growth Pact (SGP) criteria are based on the General Government Deficit as a % of GDP. General Government is a broad concept that includes local authorities and the Social Insurance Fund in addition to the Exchequer and numerous extra-budgetary funds. Despite its wider compass, the General Government Deficit (GGD) is actually smaller than the Exchequer Borrowing Requirement. This is mainly because it nets out the €1.1 billion annual contribution from the Exchequer to the Pensions Reserve Fund, which it regards as a transfer from one pocket to another.

² The 2002 Budget benefited from once-off receipts to the tune of almost €2 billion.

Table 1 – 2003 Budget Summary

EUR mn	Budget 2003	Forecast Outturn	Difference
Tax Revenue	31,646	31,396	-250
Non-Tax Revenue	1,003	1,024	21
Current Revenue	32,649	32,420	-229
Pay & Pensions	12,687	12,812	125
Non-Pay Expenditure	12,595	12,668	74
EU Budget Contribution	1,365	1,215	-150
Debt Interest	2,317	2,102	-215
Current Expenditure	28,964	28,797	-166
Current Budget Surplus	3,686	3,623	-63
Capital Budget Deficit	-5,555	-5,507	48
Exchequer Deficit	-1,869	-1,884	-15
General Gov. Deficit	-885	-842	43
<i>GGD as % GDP</i>	<i>-0.7%</i>	<i>-0.6%</i>	

Indirect tax hikes resulted in a Budget Day direct impact on the CPI of 1%. This had an immediate knock-on impact on wages given that the Sustaining Progress agreement was negotiated shortly afterwards. The net effect was to further erode our international competitiveness and, over time, to add 1%, or €140 million, to the Exchequer pay bill. The 2003 Budget was also pro-cyclical in that the Department's estimates, published at the time, showed that the cyclically adjusted deficit fell by 0.6%, i.e. a tightening of policy when the economy

was weakening. The 2003 Budget was more concerned with balancing the books than the economy.

Though the Budget forecasts appeared conservative, economic activity has again disappointed in 2003. At end June, tax revenue was €336 million behind the published profile and the Department signalled an emerging full year shortfall, and associated deficit overshoot, of up to €500 million. Private sector commentators generally rounded up and put the shortfall in the €0.5 to €1.0 billion range. At end-September, revenue was €275 million behind profile but the Department reaffirmed their €500 million full year estimate. By then, however, most private commentators had scaled back their projected Budget overshoots to a few hundred million.

Our analysis – see Table 1 - suggests that the Budget will come in on target again this year³. In saying this, we believe that the Government will continue to exercise strict control over spending and, in particular, that current spending will be on target save for known excesses of €90 million for parallel benchmarking, €5 million for equality claims and €25 million on non-pay spending. Offsetting this, is a €150 million saving on our contribution to the EU Budget. Capital spending is running well behind profile and there is now a possibility that it will undershoot target by up to €50 million. We take the view that the underlying economic situation is improving somewhat and that this will sustain tax receipts in the final quarter of the year. In particular, we expect VAT and Income Tax to come in on target, though this will not be evident until Schedule D payments are received in November. Stamp duties should continue to surprise on the upside, given ongoing buoyancy in the housing market. Having said that, it seems likely that the generally weaker economic situation will result in some tax undershoot, which we project at €250 million – see Table 2. Excises and Corporation Tax account for the principal shortfalls.

Table 2 – Revenue

EUR mn	Budget 2003	Forecast Outturn	Difference
Excise Duties	4,810	4,484	-326
Capital Taxes	1,070	1,045	-25
Stamp Duties	1,419	1,776	357
Income Tax	9,307	9,307	0
Corporation Tax	5,068	4,867	-201
VAT	9,826	9,824	-2
Total	31,646	31,396	-250

The swing factor for the Budget this year, as on previous occasions, is likely to be debt interest payments. The NTMA has a track record of announcing substantial debt service savings late in the day. This year, interest rates fell to unexpectedly low levels in the early part of the year when significant amounts of funding were done. We are projecting a saving of €215 million on this account.

The net result of these various assumptions is an Exchequer Borrowing Requirement (EBR) of €1.9 billion, unchanged from Budget Day, and an associated General Government deficit (GGD) of €0.8 billion or 0.6% of GDP. The latter is, in fact, slightly below the Budget Day target of 0.7% of GDP.

³ This would be a repeat of the 2002 experience when anticipated large overshoots failed to materialise and the Budget was on target, to the delight of the Minister for Finance and the chagrin of private sector pundits.

2004 Budget

A budgetary shortfall of €0.5 billion in 2003, if it were to materialise, would have severe knock-on consequences for next year's Budget because it would raise the opening deficit by a similar amount. This possibility, allied to mildly alarmist comments from Government sources, has created the impression that the 2004 Budget will be the toughest in a decade. The Department of Finance is, of course, happy to acquiesce in this as it helps to curb unrealistic expectations in the spending departments. Our forecast that the 2003 Budget is on target leads to a much more favourable, albeit still difficult, 2004 Budget.

Decisions on the 2004 Budget should be taken in a medium term context. We have, therefore, drawn up Budget projections for the period 2003 – 2007. These show that the General Government Deficit will rise sharply to 1.5% in 2004 before tapering off gradually to 0.8% by 2007⁴. Given reasonably tight control on public sector current spending and numbers, the prospective Budgetary situation can facilitate continued capital investment of 5% of GNP per annum without having to resort to higher taxes or particularly severe spending cuts. Critical to this, however, is a willingness to allow the deficit to rise to 1.5% of GDP next year, i.e. 0.3% above the 2004 GGD projection in last December's Budget.

Economic Forecasts

Our economic projections are set out in Table 3. We have adopted a conservative approach based on a slow eurozone recovery and muted investment inflows over the next few years. Real GNP growth is forecast at 2.5% in 2004 and 3.5% in 2005 before rising sharply thereafter. While the slow early trajectory largely reflects the external situation, the subsequent acceleration owes much to domestic developments. The scale of SSIA saving is such that when they mature in 2006 and 2007, there will be a potential massive injection of spending power into the economy. The total release over the two-year period is more than € billion⁵. At the moment, the equivalent of 3 to 4% of Personal Consumption (PCE) is diverted annually into SSIA's. In 2006, this will reverse with a net pay out equivalent to 2.5% of PCE and in 2007 the outflow will jump to 14% of PCE. Like many Government attempts to interfere with the market, the SSIA's have had the opposite effect to that intended. Given their late introduction and slow initial uptake, they are now withdrawing substantial purchasing power from the economy and when they mature there is a distinct possibility that they will generate an inflationary spending boom.

Table 3

Economic Projections				
	ESRI GNP	OUR GNP	SSIA	SSIA % PCE
	%	%	EUR bn	%
2002	0.1	0.1	-1.7	-2.9
2003	2.4	1.5	-2.1	-3.4
2004	2.9	2.5	-2.3	-3.6
2005	4.7	3.5	-2.8	-4.0
2006	5.7	5.0	2.0	2.6
2007	5.6	6.0	11.3	13.7

Media reports indicate that attempts may be made to divert maturing SSIA's into pensions and, no doubt, many of them will roll over into other forms of saving. One way or another, however, it seems likely that a substantial proportion of the proceeds will be spent, thereby boosting domestic consumption in 2006 and 2007 and causing GNP growth to accelerate.

⁴ The 2008 Deficit should continue to fall, other things being equal, given that the full impact of the ending of the SSIA drain on the Exchequer will not materialise until then.

⁵ We estimate that gross SSIA savings will be about €17.5 billion but there will be large two-way flows in 2006 when early savers will cash in their chips but late entrants will be putting away the maximum, to get a 25% one year return on their investment.

Budgetary Projections

Our budgetary projections – see Table 4 – are based on the following technical assumptions:

- Pay – amounts due under Sustaining Progress and Benchmarking will be paid on schedule. They will be followed by moderate increases in 2006 and 2007.
- Numbers – the Government will go a long way towards achieving their target of reducing numbers by 5,000 but many will simply retire and total public sector employee and pensioner numbers⁶ will fall by less. Our projections assume that average numbers are unchanged in 2004, followed by a net fall of 3,000 in 2005 with increases of 2,000 and 5,000 in 2006 and 2007, respectively. Overall therefore, the total would rise by 4,000, or 1.3%, over the four-year period. This compares with a 28% increase in the six years to 2003.
- Strict control on non-pay. Because receipts from the EU will be trending down, the pressure on gross spending will be all the greater – our forecasts assume that non-pay voted current spending rises in line with nominal GNP growth in 2004 and 2005 and significantly below it in the two boom years which follow.
- Growth in debt service spending is likely to outstrip GNP reflecting a return to normality following the cleaning out of balances on hidden departmental funds in 2003, rising interest rates and higher borrowing requirements.

Table 4

	BUDGET PROJECTIONS 2003 - 2007									
	2003		2004		2005		2006		2007	
	EUR mn	%	EUR mn	%	EUR mn	%	EUR mn	%	EUR mn	%
Current Budget										
Pay & Pensions	13,071	11.3	14,056	7.5	14,647	4.2	15,513	5.9	16,668	7.4
Other Current Voted	19,715	6.7	20,765	5.3	21,938	5.6	23,280	6.1	24,971	7.3
Gross Current Spend	32,786	8.5	34,822	6.2	36,584	5.1	38,793	6.0	41,639	7.3
Less A in A	7,330	6.5	7,622	4.0	7,992	4.9	8,343	4.4	8,668	3.9
Net Voted Spend	25,481	9.3	27,200	6.7	28,593	5.1	30,450	6.5	32,972	8.3
Central Fund	3,317	18.1	3,877	16.9	4,171	7.6	4,526	8.5	4,954	9.5
Net Current Spend	28,797	10.2	31,077	7.9	32,764	5.4	34,977	6.8	37,926	8.4
Tax Receipts	31,396	7.2	32,802	4.5	34,997	6.7	37,813	8.0	41,666	10.2
Non Tax	1,024	-54.1	665	-35.1	699	5.1	750	7.3	800	6.7
Current Revenue	32,420	2.8	33,467	3.2	35,696	6.7	38,563	8.0	42,466	10.1
Current Surplus	3,623		2,390		2,933		3,587		4,540	
(% GNP)	3.4		2.1		2.4		2.8		3.2	
Capital Budget										
Voted Capital Spend	5,380	-2.3	5,680	5.6	6,026	6.1	6,501	7.9	7,133	9.7
Non Voted Capital	360	10.8	377	4.7	314	-16.7	350	11.5	375	7.1
Pensions Reserve	1,103	6.6	1,150	4.3	1,205	4.8	1,300	7.9	1,427	9.7
Total Capital Spend	6,843	-0.4	7,207	5.3	7,545	4.7	8,152	8.0	8,934	9.6
Cap Resources	1,336	-14.4	1,015	-24.0	950	-6.4	800	-15.8	705	-11.9
Capital Balance	-5,507		-6,192		-6,595		-7,352		-8,229	
(% GNP)	-5.1		-5.5		-5.5		-5.7		-5.8	
Exchequer Balance	-1,884		-3,802		-3,662		-3,765		-3,689	
(% GNP)	-1.7		-3.3		-3.0		-2.9		-2.6	
Gen Government	-842		-2,152		-1,849		-1,710		-1,408	
Balance % GDP	-0.6		-1.5		-1.2		-1.0		-0.8	
Debt/GDP	33.4%		33.3%		32.5%		31.0%		29.0%	
Debt ex Pensions	26.8%		25.7%		24.0%		21.8%		19.3%	
Memo										
GNP	108,130	4.5	113,604	5.1	120,520	6.1	130,026	7.9	142,651	9.7
GDP	135,223	4.5	142,322	5.3	151,573	6.5	164,305	8.4	180,735	10.0

⁶ The average number of public service employees and pensioners underpinning the 2003 Exchequer Pay and Pensions Bill is 310,818, of which about 66,000 are pensioners. The corresponding figure in 1997 was 242,772.

- Underlying tax revenues are forecast to increase in line with GNP using historical relationships but must then be subjected to numerous adjustments – see Table 5. Some of these reflect the impact of the indexation of personal credits and bands to wage rises, others reflect increases in excise duties in line with inflation. Many of them are the consequences of previous budgetary decisions, e.g. changes in the capital allowances regime, and in Corporation Tax rates and payment dates⁷. In addition, allowance has been made for the cost of SSIA top ups as time elapses and potential annualised returns on these accounts rise sharply.
- The target to maintain voted capital spending at 5% of GNP is achieved. This implies a capital injection equivalent in scale to that budgeted for 2003 and rising in line with nominal GNP growth thereafter. Capital receipts will, however, be under pressure. We have assumed that ERDF and Cohesion Fund receipts will wind down sharply over the period to 2008⁸. The consequence is that the Exchequer Capital Deficit rises sharply from a budgeted 5% of GNP in 2003 to 5.8% in 2007.
- We further assume that the Pensions Reserve contribution, equivalent to 1% of annual GNP, will continue to be set aside.
- We differ from the official approach in that we do not include contingency provisions for future years. Our projections, therefore, reflect the cost of financing the existing level of services and an unchanged tax system.

Table 5

Budgetary Adjustments					
EUR mn	2003	2004	2005	2006	2007
IT Indexation	-338	-297	-340	-389	-431
Excise Index	289	123	119	141	154
IT Other	16	22	-74	41	34
IT - SSIs	-98	-53	-106	9	536
CT	-46	-85	146	107	-612
VAT	187	38			
CGT	270	80			
Stamps	257	51		-100	
Total	536	-121	-255	-192	-319

The upshot of these various assumptions is an Exchequer Borrowing Requirement which rises to €3.8 billion, 3.3% of GNP, in 2004 before falling back gradually over subsequent years. As stated earlier, the associated General Government Deficit peaks at 1.5% of GDP in 2004 before also falling back to 0.8% in 2007. The Debt/GDP ratio declines gradually from 33.4% of GDP in 2003 to 29% by the end of the period. This is a gross concept - net of Pension Fund assets, the debt ratio is below 20% by 2007.

We feel that these projections depict a sustainable budgetary scenario, albeit one where continued strict control of current spending and numbers will be necessary if capital spending is to be maintained and the overall deficit kept within bounds. While no particular budgetary packages have been assumed, we have made technical assumptions regarding the indexation of personal bands and credits, social welfare payments and excise duties. The implication is that the current tax structure is maintained but further tax reform is ruled out as attempts are made to deal with the infrastructure deficit.

The progressive nature of the tax system means that failure to index it results in an increase in the tax burden. For example, if, instead of indexing Income Tax and Excise Duties as we have assumed, the Minister were to leave them as they are, the net tax gain would be €175 million in 2004. If the freeze were continued until 2007, the cumulative gain to the Exchequer would be €930 million and the tax burden would have increased by that amount.

⁷ The scale of these adjustments is much greater than ever. Note that the positive impact of the ending of SSIs in 2007 is offset by the ending of cash flow gains from the bringing forward of Corporation Tax payment dates.

⁸ However, we do not expect a similar slowdown in agricultural receipts with the result that the net impact of EU Budget changes is significant but nowhere near as radical as some commentators have suggested.

The EU Surveillance/Approval process

The EU fiscal framework is founded on the Treaty requirement for Member States to avoid excessive deficit positions defined as budget deficits below 3% of GDP with debt to GDP ratios below 60% (or falling at a satisfactory pace towards that level). The Treaty requirements are complemented by the Stability and Growth Pact (SGP) which requires Member States to achieve and maintain budgetary positions of ‘close to balance or in surplus’ over the medium term.

Earlier this year, a Commission proposal that ‘close to balance or in surplus’ be defined in underlying terms throughout the economic cycle, i.e. net of transitory effects and especially of the effects of cyclical economic fluctuations on budgets, was accepted. As a result, the 2003 Budget was assessed by reference to the cyclically-adjusted budget balance (CAB) rather than the nominal General Government Deficit. The CAB calculations are complex as they involve estimation of output gaps benchmarked against a fully employed economy⁹. Details of the latest Department of Finance and EU Commission CAB estimates are in Table 6. Notwithstanding a projected widening of the GGD in 2004 and 2005, the CAB turns marginally positive reflecting the fact that the budgetary deterioration is the result of a temporary economic downturn rather than an expansionary fiscal policy. Ireland, thus, satisfied the “close to balance or in surplus in the medium-term” and the 2003 Budget was approved by Brussels on that basis.

A favourable assessment was always likely given the restrictive nature of the 2003 Budget which tightened policy by more than 1% of GDP¹⁰. The Council noted with approval the build up of assets in the National Pensions Reserve Fund and that the low level of primary surpluses reflected the impact of multi-annual measures, particularly the investment programme. It also remarked that the estimate of the output gap “presents unusual margins of uncertainty due to the special features of the Irish economy”.

Table 6

% GDP	Adjusted Deficits			
	2002	2003	2004	2005
Budget 03				
GGD	-0.3	-0.7	-1.2	-1.2
CAB	-1.0	-0.4	-0.2	0.1
Commission				
GGD	-0.3	-0.6	-0.9	
CAB	-0.9	-0.3	+0.1	

If the 2003 Budget got the blessing of Brussels, what are the prospects for 2004? First, a 2004 GGD of 1.2% was effectively already approved in the context of the 2003 Budget exercise. Our projected 2004 GGD is somewhat higher at 1.5%. Taking the years 2003 and 2004 together, our projected cumulative GGD is slightly above 2003 Budget projections¹¹. This modest deterioration reflects the fact that there has been no change in the thrust of fiscal policy since the Budget, which is slightly ahead of target, and we have assumed unchanged policies in 2004. However, GDP growth in each of those years is well below the 2003 Budget projections. Normally, a weaker economy would cause the GGD to rise as taxes undershoot and unemployment benefits increase. The fact that this has not happened means that fiscal policy has effectively been tightened, resulting in lower CAB deficits

In fact, we forecast that the 2003 outturn CAB will be a small positive¹² and the 2004 CAB a somewhat greater positive given that the calculations are cumulative. Because the EU now focuses on the CAB medium term position, which we believe is in surplus, there should be no reason for Brussels to object to a 2004 Budget GGD of 1.5%. Therefore, there is no need for a restrictive fiscal policy in the 2004 Budget.

⁹ A Cobb-Douglas Production Function approach is used.

¹⁰ The CAB fell from 1.0% of GDP in 2002 to 0.4% in 2003 and was scheduled to tighten by 0.2% in 2004 and a further 0.3% in 2005, despite large contingency provisions of 0.4% and 0.8% of GDP, respectively, in these years.

¹¹ Our GGD figs are -0.6% and -1.5% as compared with -0.7% and -1.2% by the Dept and -0.6% and -0.9% by the Commission.

¹² The 2003 Budget will, thus, turn out to be more contractionary than expected at the time, with the CAB going from -0.9% in 2002 to a small positive in 2003. This reflects unexpected buoyancy in Stamp Duties and a set of Departmental tax revenue forecasts which were conservative relative to their economic projections.

MACRO POLICY ISSUES

Next Pay Agreement

A central focus of the 2004 Budget must be the next pay agreement. In approaching this, it does not matter whether or not we continue to have centralised pay bargaining. Budget 2003 added about 1 per cent to the consumer price index and Government generated price increases in the twelve month period before the finalisation of “Sustaining Progress” are estimated (conservatively) at 1.6%. On this basis, Government action directly added about €300 million per annum to the cost of the present pay agreement.

The next pay agreement will be concluded in mid-2004. Therefore any indirect tax increases imposed in the Budget will add directly to the rate of inflation in the critical period before its negotiation. In these circumstances, we believe that there should be no increase in indirect taxes in the next budget, i.e. any excise or VAT increases should be balanced by offsetting reductions to leave a neutral effect on the CPI. If this requires an increase in the real burden of income tax, this is a price worth paying as we attempt to make the transition to rates of pay increases which maintain our competitive position in the Eurozone. Our earlier projections indicate, however, that this can be achieved without having to raise income tax.

Control of Public Spending

Public Spending has increased rapidly in recent years. In the period 1997 to 2003, gross public spending went up from €18.9 billion to €38.2 billion. Detailed Figures are in Table 7. This increased expenditure has been accompanied by very substantial increases in employment.

	1997 €bn	2003 €bn	% Increase
Health	3.6	9.2	155.5
Education	3.2	5.9	84.4
Social Welfare	5.7	10.2	78.9
Capital Spending	2.0	5.5	175.0

It is likely that during a period of such rapid expansion the focus on cost efficiency was less than it might otherwise have been and that a period of consolidation is now necessary. One option is to ask each public sector agency to surrender 2% of payroll costs to a central pool each year. Of this a proportion (say half) might be reallocated to cater for areas which are expanding. Such a mechanism is necessary to divert resources from areas of work that should contract to those in which demand is increasing. We note the recommendation of the Three Wise Men that an “efficiency dividend” of 2% be imposed on administrative expenditure. This needs to be supplemented by an explicit limit on payroll costs.

Stability and Growth Pact

Some believe that the SGP excessively constrains infrastructure investment in countries like Ireland. While the Pact provides no special treatment for public investment, it is taken into account in the excessive deficit procedure (EDP). The Commission activates the EDP if the actual or planned deficit goes above 3% of GDP. However, Article 104(3) states that in preparing its report, the Commission “*shall also take into account whether the government deficit exceeds government investment expenditure*”.

In 2002, the Commission went one step further when it proposed that the ‘close to balance or in surplus’ requirement could be interpreted to cater for large structural reforms (such as productive investment or tax reforms) that raise employment or growth potential in line with the Lisbon strategy and/or which in the long-term improve the underlying public finance positions. In particular, they proposed that:

- (a) small temporary deteriorations in the underlying budget position could be envisaged only if the Member State concerned has already made substantial progress towards the ‘close to balance or in surplus’ requirement and if general government debt is below the 60% of GDP reference value, and

- (b) a small deviation from the ‘close to balance or in surplus’ requirement of a longer-term nature could be envisaged for Member States where debt levels are well below the 60% of GDP reference value, and when public finances are on a sustainable footing.

The latter suggestion is a ‘golden rule’-type fiscal policy, permitting long-term deficits to finance planned investment, albeit while staying well below the over-riding 3% limit. It looks tailor made for Ireland.

The Commission subsequently reported that these proposals were subject to intense debate with concerns being raised about their practical feasibility. In the end, the Council agreed, in March 2003, to a generalised version of the proposal when they undertook to pay greater attention to country-specific circumstances and to the longer-term sustainability and quality of public finances with a view to increasing the growth potential of the EU economies in conformity with the Lisbon agenda.

We recommend that the Irish authorities should now produce an investment plan for the period to 2010 and, in this context, secure EU agreement that “close to balance or in surplus” be interpreted as a CAB of 1% with a 0.5% error margin either side of that¹³. Other things being equal, that means that the GGD would be 1% higher than otherwise, voted capital spending would increase from 5% to 6% of GNP and the debt ratio, instead of falling, would be 33% of GDP in 2007, unchanged from 2003.

We believe that Ireland should only do this if the additional resources are clearly devoted to specified infrastructural or research projects which yield tangible benefits. Given our relatively strong public finances, low debt ratio, favourable demography and relatively good funding of pensions liabilities, such an approach would be prudent and sustainable, provided there is sufficient capacity among providers of infrastructure to avoid much of the gains being lost through higher inflation. We further recommend that capacity in the building sector be specifically taken into account in future investment plans.

National Pensions Reserve Fund

The huge infrastructural deficit, allied to the rapidly growing size of the National Pensions Reserve Fund has led to calls for the Fund to finance major infrastructural projects with a view to increasing capital spending without raising the GGD. The Fund, for its part, has made it known that it is prepared to invest in suitable projects provided the remuneration is adequate. We believe these calls are misguided.

First, the Pensions Fund could invest directly in physical infrastructure but this would be treated as additional spending thereby pushing up the GGD and defeating one of the original objectives¹⁴.

Second, the Pensions Fund could participate in PPP projects without raising the GGD as the Fund would merely be swapping one type of equity for another. However, when Government assets are financed by the private sector under PPP contracts, in return for a pre-determined stream of future payments, the identity of the effective economic owner of the assets must be established by Eurostat, the EU statistical agency. If the balance of the risks and rewards of ownership remains with the Government, the asset is recorded on the balance sheet of the Government, thereby neutralising the original intent of the PPP. It follows that only PPPs which overcome this hurdle can achieve the twin objectives of increasing net investment without raising the GGD.

Where such projects do exist, there is no evidence of lack of funding from the private sector. In practice, the Pensions Fund is likely to compete with banks and others to supply funds for a limited range of viable PPP projects but its participation, as such, is unlikely to increase total capital spending. When it comes to boosting infrastructure investment, therefore, the Pensions Fund is a red herring.

¹³ Because they are difficult to estimate, and to reflect the inherent uncertainty of the exercise, the Commission applies an informal 0.5% margin around zero in assessing CAB's. Arguably, the Irish margin of error should be higher given the huge structural changes in the economy over the past decade.

¹⁴ Moreover, this is hardly a sensible approach given that the cost to the Government is the marginal cost of borrowing which is likely to be considerably below the return the Pensions Fund would require, given its mandate.

TAX REFORM & THE REAL TAX BURDEN

Evolution of Income Tax Burden

Much progress has been made in reforming the Irish income tax system and in reducing the tax burden on workers. The OECD has published¹⁵ an analysis of trends in the direct tax burden on average workers since 1979. The burden of income tax plus social insurance contributions for single workers without children has tended to increase in most OECD countries. In many countries this rise was limited to 2-6 percentage points. However, the personal average tax rate in Ireland fell between the late 70's and the early 2000's by 11 percentage points (second only to Turkey where the fall was 19 percentage points). The figures include cash benefits. Significantly, Ireland opened up a substantial gap with the UK where our tax burden is now 6.4 percentage points lower for single workers (16.9 v 23.3) – see Table 8.

The trends for a married couple with two children are broadly similar. Here, the Irish burden fell by 12 percentage points since 1981 and we have opened up a gap with the UK of 8 percentage points of income.

The direct tax burden for Irish workers has been transformed and is now amongst the lowest in the OECD.

The Tax Burden

Some argue that the process of tax reduction may have gone too far and that an increase in taxes is now necessary if we are to enjoy first class public services. We now examine the evidence. Table 9 gives the latest information in relation to the tax burden in OECD member countries.

Table 8				
Average Worker Tax Burden				
	1981	1991	1996	2001
Single Person				
Ireland	28.1	32.4	28.5	16.9
UK	31.2	26.2	25.8	23.3
Ranking	13	6	10	26
Countries	24	25	29	30
One Earner family with 2 Children				
Ireland	14.9	20.8	14.6	2.3
UK	19.4	16.5	17.3	10.3
Ranking	12	5	17	28
Countries	24	25	29	30
Income Tax plus Employee PRSI				
Source: Taxing Wages OECD				

Table 9			
Total Tax Revenue as % of GDP (2001)			
Austria	45.7	Norway	44.9
Belgium	45.3	Poland	34.1
Czech R	39.0	Portugal	34.5
Denmark	49.0	Slovak	33.1
Finland	46.3	Spain	35.2
France	45.4	Sweden	53.2
Germany	36.4	Switz	34.5
Greece	40.8	Turkey	35.8
Hungary	38.6	UK	37.4
Iceland	34.8		
Ireland	29.2	OECD	37.6
Italy	41.8	EU 15	41.9
Lux	42.4	IRL GDP	29.2
N'Lands	39.9	IRL GNP	34.5
Source OECD			

The latest OECD figures relate to 2001. These show that taxation in Ireland as a percentage of GDP is 29.2 per cent compared to an OECD average of 37.6 per cent. The EU average is 41.9 per cent.

These figures give a poor indication of the relative tax burden in Ireland as it is necessary to adjust them for the lower level of GNP in Ireland. It is well known that GDP is a very poor measure of taxable capacity for Ireland. In most countries GDP and GNP are almost identical. However, in Ireland due to the importance of the multi-national sector, GNP is about 80 per cent of GDP. Even with this adjustment Ireland still raises a relatively low amount in taxation of 34.5 per cent of GNP. We lie at the bottom of the 15 EU countries along with Portugal and just below Spain, Germany and the UK. Our tax burden is substantially above advanced countries such as US (29.6), Japan (27.1) and Australia (31.5).

¹⁵ Taxing Wages 2000-2001 OECD, Paris 2001.

Services

Does this imply that our public services must be worse than other EU countries? Before we can answer this question, there are a number of special factors that must be taken into account. These include:

- Differences in debt service costs
- Differences in unemployment rates
- Differences in defence spending
- Capital spending requirements
- Differences in the way pensions are funded
- Demographic differences
- Payments to the National Pensions Reserve Fund

We discuss each of these in turn. The results are summarised in Table 14.

Debt Service Costs

Table 10 shows Ireland's relative indebtedness compared to other EU countries. We are now in second place behind Luxembourg or third if we use GNP for Ireland.

Interest on Government Debt in Ireland now takes about 1.8 per cent of GNP compared to an EU average of 3.1 per cent – while such a saving appears small it is significant in that it amounts to the total yield from stamp duties or in excess of the amount spent on third-level education.

The reduction in our national debt to well below half the EU average has cut the amount of tax revenue needed to service debt by 7.5 per cent of GNP over the last 15 years. That makes a lot more available to fund public services.

% GDP	Debt	Interest	% GDP	Debt	Interest
Austria	68.5	3.5	Lux	4.1	0.2
Belgium	102.7	5.5	N'Lands	52.4	3.0
Denmark	42.7	3.3	Portugal	59.4	3.1
Finland	42.3	2.2	Spain	52.5	2.7
France	61.8	3.2	Sweden	50.9	2.7
Germany	62.7	3.2	UK	39.0	2.0
Greece	101.0	5.2	EU avg	34.7	3.1
IRL	33.3	1.5	IRL GNP	40.2	1.8
Italy	106.0	5.3			
Source EU 2003 data					

Austria	4.3	Italy	9.0
Belgium	7.3	Lux	2.8
Denmark	4.5	N'Lands	2.7
Finland	9.1	Portugal	5.1
France	8.7	Spain	11.3
Germany	8.6	Sweden	4.9
Greece	10.0	UK	5.1
IRL	4.4	EU 15	7.7

Unemployment Rates

Table 11 shows unemployment rates. Different rates of unemployment have dramatic effects on budget deficits. A reduction in unemployment translates a negative social welfare payment into a positive tax payment. For example, for every married person on average industrial earnings who becomes unemployed, the cost to the taxpayer is about €18,000. The additional social welfare cost of a 1 per cent rise in unemployment is about €200 million.

Our rate of unemployment is about 3 percentage points below the EU average, which saves us about €600 million or 0.5 per cent of GNP.

Defence Spending

Defence spending in Ireland is lower than in any EU country except Luxembourg. In 2002 we spent about 0.7 per cent of GNP compared to an average of 2.0 per cent of GDP for EU countries in NATO. This means that, other things being equal, our spending should be 1.3 per cent of GNP less.

Belgium	1.3	Lux	0.8
Denmark	1.5	N'Lands	1.6
France	2.6	Portugal	2.1
Germany	1.5	Spain	1.2
Greece	4.8	UK	2.4
Irl GNP	0.7	Avg(Excl Irl)	2.0
Italy	1.9		

Source NATO and Department of Defence 2002

	Public	Old ¹		Public	Old ¹
% GDP 97	%	2010	% GDP 97	%	2010
Austria	13.5	30.1	Italy	16.3	35.5
Belgium	11.5	31.1	Lux	10.4	27.6
Denmark	11.7	29.6	N'Lands	10.9	26.2
Finland	9.6	29.7	Portugal	8.5	28.5
France	12.8	29.5	Spain	9.6	30.7
Germany	12.0	34.1	Sweden	13.1	33.8
Greece	11.7	33.6	UK	11.8	28.5
Ireland	4.2	20.5	EU	12.4	31.4
			IRL GNP	5.2	

¹Old Age Dependency Ratio = +65 / 20-64 age group
Source: EU Commission 2000

Pensions Funding

In most EU countries, the bulk of the expenditure for old age and survivor benefits comes out of statutory pension schemes and is financed out of social insurance contributions and general taxation. Ireland is significantly different in that most pensions are financed on a pay-as-you-go basis in the public sector or through funded private schemes. An EU study¹⁶ has estimated that old age and survivors benefits on average took 12.4 per cent of GDP in 1997 compared to 4.2 per cent in Ireland (GNP 5.25 per cent).

Eurostat figures (Abramovici) for 2000 show expenditure on pensions in the EU 15 to be 12.5 per cent on average, compared with 3.6 per cent in Ireland (GNP 4.2 per cent) – a difference of 8.3 per cent. This factor accounts for a significant difference in observed tax ratios.

Demography

Much of the concern about a demographic crisis is due to worsening dependency trends. At the peak of economic dependency in the mid-1980's, there were nearly 230 dependants for every 100 workers. This ratio is expected to fall to 125 dependants per 100 workers by 2010, well below the current EU average.

Old age dependency in Ireland (Ratio of population over 60 to the population aged 20-59) is estimated at 27.8 per cent – the lowest in the EU. The EU average is 40.9 with Germany having a ratio of 45.4¹⁷.

It is difficult to quantify the effect of this but it clearly is helpful. A Fraser Institute study of health spending in Canada notes that those aged 65 years and over consume more than three times the average spending for all age groups while those over 85 consume more than nine times the average. Their estimate is that in 1999 Ireland's favourable demographic structure was worth about 2.5 per cent of GDP (2.9 per cent of GNP) in a requirement for lower health spending.

While one would expect the need for education spending (5.9 per cent of GNP) and child related welfare spending to be somewhat higher than in other EU countries, this is unlikely to match the large saving on health spending. It is clear that our favourable demographic structure implies a lower need for public spending to provide an equivalent level of public services.

¹⁶ The Future Evolution of Social Protection from a Long-Term Point of View: Safe and Sustainable Pensions" October, 2000.

¹⁷ Social Protection: Expenditure on Pensions, Gerard Abramovici, Eurostat Statistics in Focus Series, Theme 3 –11/2003.

Capital Expenditure

Ireland's infrastructure is clearly deficient, which means that we have to spend a greater proportion of our resources on investment than countries with more developed infrastructure. Under the terms of the Stability and Growth Pact, no distinction is made between current and capital spending. Ireland is spending about 5 per cent of GNP on public investment compared to an EU average of 2.9 per cent.

National Pensions Reserve Fund

Ireland is allocating 1 per cent of GNP to provide for social welfare and public sector pensions in future years. This is not contributing to the volume of public services now. Hence, we have deducted this in computing the adjusted tax ratio for Ireland.

Table 14	
Tax Burden Adjustments	
Ireland Tax/GNP	34.5
Add:	
Unemployment	0.5
Debt Service	1.3
Defence	1.3
Social Security	7.2
Total	44.8
Deduct:	
Capital Spending	2.1
NPRF	1.0
Adjusted Tax ratio	41.7
EU average	41.9

Conclusion

All this supports the view that structural factors result in Ireland having a relatively low tax burden without having to sacrifice the quality of important public services (assuming equal efficiency of Irish public administration).

When one adjusts for these factors, the tax burden in Ireland is 41.7 per cent compared to an EU average of 41.9 per cent. This suggests that whatever may be wrong with the Irish economy and the standard of public services we have, it is not due to a lack of taxation.

TAX POLICY ISSUES

Social Insurance: Contributory Principle

There has been debate about whether or not social insurance should be financed from general taxation or funded on a contributory basis. Further details on the financing of social insurance are in Appendix 1.

What is clear is that we have a hybrid system and that the link between benefits and contributions has weakened over the years. Flat rate benefits are financed by pay-related contributions. In addition, some people get credited or free contributions during periods of unemployment, incapacity for work and maternity leave. The Report on Integration of Tax and Welfare (TWIG, 1996) found that credited contributions were very important in that in 1991/92 the majority of the insured population had some credits; 37 per cent had a mixture of contributions and credits and 29 per cent had credits only.

It would be possible to maintain the contributory principle on the basis of employer contributions only as is the case with many occupational pension schemes. Such a change was favoured by some members of the Tax and Integration Working Group (Para 7.28) on the grounds that it would:

- Increase social solidarity by getting everyone to contribute to the social welfare system which is the most powerful individual mechanism we have for protecting the weaker sections of the community.
- Partly shift the tax burden from income from work to other income (e.g. rental income, investment income and income accruing to retired persons) thereby contributing to the reduction in unemployment and poverty traps.
- Remove a regressive form of taxation.
- Greatly simplify the system.

Employee PRSI

There are 30 different classes of PRSI contribution and the system is very complicated. The employee's portion of the social insurance contribution is paid on earnings up to a ceiling of €40,420. Employees who earn not more than €287 in any week are exempt from paying PRSI for that week. There is no annual refund payable to employees whose weekly earnings fluctuate above and below the €287 exemption limit.

The weekly (non-cumulative) PRSI-Free Allowance for employees with weekly earnings in excess of €287 is €127 per week. (This allowance does not apply to the Health Contribution and it does not affect the employer's contribution).

A Department of Social and Family Affairs paper¹⁸ to the Tax Strategy Group notes that “While the introduction of the €287 weekly PRSI Exemption delivered an increase in net pay for all those earning between €127 and €287 per week, it had a number of negative effects, including introducing a significant “step effect” - once earnings move from €287 to €287.01 per week, Employee PRSI contributions increase from NIL to €1.48 per week.

Despite the fact that every effort was made to minimise complexity, the exemption increased the complexity of the system and necessitated the introduction of 4 new sub-classes to cater for the changes.

The Department went on to propose that the exemption should be phased out by progressively raising the PRSI Free Allowance to €287 per week over a series of Budgets. The Department also discussed the abolition of the ceiling on employee contributions, which was estimated to yield €90 million. It said this would strengthen the social solidarity element of the system in that a proportion of all income would be pooled for the benefit of all contributors.

¹⁸TSG 02/21, October 2002

If the objective is to strengthen social solidarity, then all taxpayers should make a contribution based on their ability to pay. This could be achieved by restoring the Exchequer contribution to the Social Insurance Fund from general taxation to historic levels in line with the vision propounded in the Beveridge Report. The strategic objective should be to phase out employee contributions entirely and replace them with an Exchequer contribution funded from general taxation to reflect the principle of social solidarity. Given that employees now contribute directly only 20 per cent of Fund income, a restoration of the Exchequer contribution to historical levels would be more than sufficient to eliminate employee PRSI.

This would have the advantage of reducing administrative and compliance costs by simplifying the PAYE system. It would also reduce the tax wedge on those active in the labour market by shifting the tax burden to pensions and unearned income. By equalising the tax burden on employees and pensioners, it would increase the relative contribution of pensioners before demographic change substantially increases their numbers thereby putting the public finances on a more sustainable footing in the long term.

An increase of 2 percentage points on each rate of income tax would be more than sufficient to abolish employee PRSI and allow some reduction in the contribution rate for the self-employed who would not get any benefit from the abolition of employee PRSI.

Employer PRSI

The 2003 rate structure for employer PRSI is as follows:

Up to €356 weekly earnings - 8.5 %; over €356 weekly earnings - 10.75 % on all earnings.

The effect of this is to introduce a step change of over € per week when an employee goes over the €356 per week limit.

The strategic objective should be to move to a single rate employer PRSI contribution. The yield from extending employer PRSI to benefit-in-kind payments from January 2004, €83 million, should be used to reduce the higher rate of employer PRSI.

CGT Indexation

An important policy change was made in the 2003 budget when it was announced that “indexation of the base for computation of capital gains will only be allowed to be calculated up to 31 December, 2002”. This major change was justified on the basis that “All of these reliefs and allowances made sense when CGT rates were 40 per cent and 60 per cent”. The other reliefs referred to were roll-over relief and tax deferral through the use of loan notes.

The abolition of indexation was a major error akin to justifying the abolition of depreciation allowances on the grounds that tax rates were low. It should be an important principle of tax policy to get the base right before applying the appropriate rate of tax – abolition of indexation distorts the base in a most arbitrary way. It is very damaging in the long-term. It involves a major increase in effective tax rates.

To take a simple example, assume an asset is bought now and that it doubles in value over the next ten years. Assuming inflation is 5 per cent a year, the effective rate of capital gains tax is not 20 percent, not even 40 per cent but 57 per cent. If it doubles in one year the effective rate of tax is 21 per cent.

The abolition of indexation favours speculation. As Kay & King¹⁹ conclude: “The real losers from inflation are those who make modest nominal gains. To compensate investors for inflation requires providing relief which is proportional to the initial investment not to the resulting gain.”

The abolition of indexation for capital gains tax should be reversed.

¹⁹ “The British Tax System, page 49”

Carbon Tax

The 1997 Kyoto Protocol, for the first time, sets greenhouse gas emissions limits for the developed world. Ireland, under the EU “bubble”, has committed to limit the increase in greenhouse gas emissions to no more than 13 per cent above the 1990 level by 2008-2012. The latest “business as usual” projections suggest that, without offsetting action, emissions will rise by around 23-28 per cent over this period.

The national climate change strategy, published in November 2000, sets out a ten-year framework for achieving the necessary greenhouse gas emissions reductions to ensure that Ireland complies with the Kyoto Protocol. Sectoral measures included in the strategy are intended to reduce emissions by over 15 million tonnes CO₂ equivalent during the commitment period 2008 to 2012 per annum. No specific target for taxation measures is included in the Strategy.

The 2003 Budget stated that “Government has asked relevant Departments to advance plans for a general carbon energy tax, with a view to introducing this from the end of 2004. Given the many implications of such a tax, both environmental and economic, there will be full consultations with interested parties on the design of a tax and a reasonable period is being allowed for its effective introduction”.

The Department of Environment and Local Government has proposed a tax rate of €7.50 per tonne initially rising to €20 per tonne over a period of 3 to 4 years. The revenue raised is estimated to be €200 million initially rising to €10 million at €20 per tonne in 2010 with exemptions for emissions trading as proposed in the Department of Finance consultation paper issued in July, 2003. A number of points should be made:

First, the proposed exemption from carbon tax for emissions trading is welcome and justified on sound principles.

Second, the trading regime and the alternative of proposed fines will have a significant adverse effect on the competitiveness of certain sectors.

Third, a substantial proportion of emissions, most notably in the agricultural sector, will not be subject to the carbon tax or trading regime. (Agriculture generates about 33 per cent of emissions in Ireland).

Finally, the carbon tax is estimated to cut carbon dioxide emissions by more than 2 million tonnes. Under the Kyoto Agreement, Ireland is supposed to keep emissions to 61 million tonnes from 2008 but already produces almost 70 million tonnes – and this is set to rise to 73 million tonnes, so the tax will make a small contribution to meeting the emissions target.

There are a number of options for recycling the yield from a carbon tax:

1. Use the money to compensate less well off households. Proponents of this option argue that expenditure on fuels as a proportion of income is higher for lower income groups (than for higher income ones) and that the fuels used by the lower income groups tend to have the highest carbon content (coal, peat) and would therefore attract the higher taxes.
2. Some European countries (Denmark, the Netherlands and the UK) pursue a revenue-neutral policy and channel their carbon tax ‘take’ back to households and/or business affected by the tax.
3. Norway, Sweden and Finland follow the line that carbon tax revenue is simply another contribution to general government revenue and should be used to fund overall government expenditure.
4. Use the money for general tax reductions.

We believe that the yield should be entirely devoted to tax reductions. Given the adverse effects on Ireland’s competitiveness of the Kyoto regime, these tax reductions should be focussed on improving competitiveness to the maximum possible extent²⁰.

²⁰ Our medium-term budgetary projections do not include any yield from carbon taxes.

Demographic Change

The implications for public expenditure on higher pensions and health are the subject of frequent discussion – less frequently discussed are the implications for tax revenue arising from the prospective ageing of the population. Age significantly affects the amount of tax and PRSI paid – Table 15.

On an income of €30,000 a married person aged over 65 pays €3,500 less in taxes than a PAYE worker. As a result their net income is almost 14 per cent higher despite the fact that the young are likely to have mortgages and higher car insurance and child care expenses (after child benefit). The old have community rating for medical insurance premia, free public transport and medical cards (over 70).

For a single person on an income of €30,000, the income differential is almost 5 per cent. Revenue Commissioners data for 2000/01 show that those aged 65 and over paid tax at an average rate of 13.6 per cent of their total income, €20,307, compared to 19.1 per cent for others (total income €24,889). These figures do not take account of social insurance contributions.

The balance between these groups is open to question. While a change is primarily justified on equity grounds, a relative shift in the balance of taxation from the young to the old could make an important contribution to fiscal sustainability.

The differential arises from two factors mainly; the relatively high income tax exemption threshold particularly for married couples and the fact that older people do not pay PRSI. Three measures would help to address this:

- An increase in personal tax credits
- A freezing of the exemption thresholds and
- A shift from employee PRSI to income tax as recommended above.

	30,000	30,000	60,000	60,000
Income				
Married	PAYE	Over 65	PAYE	Over 65
Total IT & PRSI	4,136	600	17,752	15,990
%	14	2	30	27
Net Income	25,864	29,400	42,248	44,010
Single	PAYE	Over 65	PAYE	Over 65
Total IT & PRSI	5,656	4,515	19,272	17,715
%	19	15	32	30
Net Income	24,344	25,485	40,728	42,285

Recycle SSIA's

Based on our earlier forecasts, the maturity value of SSIA balances will be about €17.5 billion. These are due to mature in the year from mid-2006 onwards. Personal consumption in 2007 is estimated at about €80 billion (ESRI MTR 2003-2010). The implications of having a large boost to personal consumption from maturing SSIA balances needs to be considered.

A number of options merit consideration. The first is to provide some incentive for people to extend their SSIA's beyond the original maturity date if only to spread the boost to consumption over a longer period.

The second is to provide an additional incentive for those with inadequate pension coverage to put the funds in PRSA's or some other pension vehicle. While significant incentives already exist to do this, some additional targeted incentive aimed at those with inadequate pension provision may be justified.

CONCLUSIONS

We conclude that:

- The 2003 Budget is on or slightly ahead of target.
- A restrictive fiscal policy in 2004 is neither necessary nor desirable.
- The 2004 Budget will be difficult but by no means insurmountable. A combination of tight control on spending and numbers together with a more buoyant economy and a willingness to let the deficit rise to 1.5% of GDP should allow capital spending of 5% of GNP without having to resort to tax rises or spending cutbacks.
- This should be acceptable to the EU as the underlying budget position will probably be in surplus, thereby conforming with the Stability and Growth Pact requirement that the Budget be close to balance or in surplus in the medium term.
- It is critical that the Budget should not increase the CPI in advance of the next wage agreement. The objective should be to lower inflation to 2% to enhance competitiveness. This means that any excise tax hikes should be balanced by equivalent reductions in other duties.
- A mechanism needs to be devised to divert resources from contracting to expanding areas in the public sector. Departments could surrender 2% of payroll costs to a central pool each year with provision for some reallocation to priority areas.
- An updated Investment Plan for the period to 2010 should be produced. In this context, EU agreement to run a medium-term underlying budget deficit of 1% of GDP should be sought.
- The objective should be to boost capital spending from 5% to 6% of GNP, provided worthwhile projects can be found.
- Future Investment Plans should make specific allowance for capacity in the construction sector. Additional spending should be contingent on spare capacity existing or external resources being used.
- The Pensions Reserve Fund is merely an alternative source of funding and it is unlikely that participation by it in PPPs will boost total spending on infrastructure over coming years.
- The problem is not one of inadequate funding, rather a limited supply of viable PPP projects.
- We have made major progress in reforming our tax system since the mid-eighties; the challenge now is not to reverse the progress that has been made.
- There is no evidence that the burden of taxation in Ireland is insufficient to deliver good public services by international standards given the relatively favourable structural factors we face over the next decade.
- The outlook for the public finances in the medium term does not give cause for concern provided there is reasonable control of public spending; while the rates of spending increases in recent years are unsustainable, there is no need for a return to the restrictive spending policies or the tax increasing policies of the eighties.
- While tax reductions of the scale experienced in recent years are neither necessary nor desirable, there is scope for substantial tax reform in the following areas:
 - Financing of social insurance, most notably by abolishing employee PRSI contributions
 - Simplification and reduction of the employer PRSI contribution
 - Restoration of indexation for capital gains tax purposes
 - Recycling of proposed carbon tax to help competitiveness
 - A change in the relative balance of taxation between the young and the old
 - Recycling the proceeds of SSIs.
- The overriding medium-term fiscal focus should be on a sustained and coherent programme to remedy infrastructural deficits. It should be possible to do this while, at the same time, maintaining the tax reform gains of recent years while avoiding further increases in an indirect tax burden that is already undesirably high.

October 2003

Appendix 1

Social Insurance Fund

The Commission on Social Welfare found that tripartite funding – by employers, employees and the State – is a feature of social insurance schemes in most countries and has applied in the Irish system since its inception. Tripartite funding is in line with the original Beveridge Vision of Social Insurance. The TWIG Report concluded that “the principle of an Exchequer contribution to the Fund should be maintained and reflect a commitment to social solidarity”.

The Financing of the Social Insurance Fund has developed as follows

	Employers %	Employees %	State %	Other %	Self -Employed %
1965	29.5	28.0	39.9	2.6	
1980	54.5	21.4	23.7	0.3	
1990	63.8	26.2	5.9	0.4	3.7
2000	74.2	20.0	nil	0.7	5.1
2001	75.1	19.5	nil	1.1	4.4

The Fund is now in surplus (€687 million in 2000 excluding a payment of €152 million to the National Training Fund). The 2000 surplus is equivalent to 18.8 per cent of expenditure on Social Insurance schemes. The estimated surplus in 2003 is £1.5 billion (1.4 per cent of GNP).

In fact, employer and employee contributions exceeded total expenditure on social insurance by £293 million in the year 2000.

The surplus in the Fund that has emerged in recent years is invested by the NTMA. In addition, one-third of the annual Exchequer contribution to the National Pension Reserve Fund of 1 per cent of GNP is earmarked to pay Social Insurance benefits in the future.

In his 2000 Budget Statement, the Minister for Finance indicated that the Social Insurance Fund is in a healthy financial situation and that this position was projected to strengthen further in the immediate years ahead. In his 2001 Budget Statement the Minister said:

“Since its inception in 1953, the Exchequer has assisted the Social Insurance Fund. For instance, in the ten years to 1996, the Exchequer contribution exceeded €2 billion. Thanks to this Government’s record on employment, the Fund is now in such a healthy financial position that the Exchequer can recover some of this funding. The Fund will have about a €1.4 billion surplus at the end of 2001. I indicated last year that it is important to keep the surplus under review. Having regard to its strong financial position, I am satisfied that it is appropriate for the Fund to make a contribution of €635 million in 2002 towards the Exchequer. Taking account of the other changes I am announcing today, the Fund will still have €1.2 billion in hand at the end of 2002”.

Administrative Costs

The administration costs of the social insurance system in the year 2001 charged to the Social Insurance Fund were €159 million or 4.3 per cent of expenditure from the Fund (down from 4.6 % in 2000). The administrative cost of the social assistance schemes was €216 million or 5.2 per cent of the expenditure on these schemes (up from 5 per cent in 2000).

One would expect a greater administrative cost for social assistance due to the need for means tests etc. The relative administrative costs of social insurance compared to social assistance declined from 93 per cent in 2000 to 83 per cent in 2001.

Actuarial Review of Social Welfare Pensions

The Actuarial Review of Social Welfare Pensions (2002) concluded that if social welfare pensions increased in line with average earnings, the additional cost as a percentage of GNP over that in 1996 would be as follows:

2016	nil
2036	2.1 per cent
2056	3.2 per cent

To illustrate the sensitivity of the SIF to future possible changes in benefit rates, four possible scenarios were considered in the review, and conclusions were drawn as follows:

If payments were increased in line with price inflation only, spending on retirement and old age pensions would represent 2.1% of GNP by the end of the period (2056) and the SIF would remain in surplus if contribution rates remained constant;

If payments were increased in line with earnings, spending on retirement and old age pensions would represent 6.5% of GNP by the period, with the result that the SIF surplus would be exhausted by 2015 on the assumption of unchanged contribution rates;

The analysis was also carried out on the basis of a number of the illustrative scenarios identified by the Social Welfare Benchmarking and Indexation Group in its 2001 report.

If the minimum payment were to be set at 27% of Gross Average Industrial Earnings by 2007, spending would amount to 7.6% of GNP in 2056 and the SIF surplus would be exhausted by 2007;

If the minimum payment were to be set at 30% of Gross Average Industrial Earnings by 2007, spending would amount to 8.5% of GNP in 2056 and the SIF surplus would be exhausted by 2005.

These figures look large until one notes that the amount charged to taxation for debt service has declined from 11.1 per cent of GNP in 1985 to 3.6 per cent in 1999 – a decline of 7.5 per cent.

References

An International Comparison of Health Care Systems” Nadeem Esmail and Michael Walker, Fraser Forum August, 2002.

Budget 2003, the Stationary Office, December 2002

Integrating Tax and Social Welfare, Report of Expert Working Group, June 1996

Medium Term Review 2003-2010 no 9, ESRI, July 2003

Production Function approach to calculating potential growth and output gaps, European Economy, Economic Papers, September 2002

Public Finances in EMU 2003, European Economy no 3 2003

Revised Estimates for Public Services, Government Publications Sales Office, February 2003

Social Protection: Expenditure on Pensions, Gerard Abramovici, Eurostat Statistics in Focus Series, Theme 3 –11/2003

Sustaining Progress: Social Partnership Agreement 2003-2005, February 2003

Taxing Wages 2000-2001 OECD, Paris 2001

Tax Strategy Group Papers, Department of Finance website

The British Tax System, J A Kay and M A King, Oxford University Press, 1980

The Future Evolution of Social Protection from a Long-Term Point of View: Safe and Sustainable Pensions, October, 2000, EU Commission

Acknowledgements

In preparing this paper we are very grateful for the great deal of help we received from a number of people in the public service. All opinions and errors are our responsibility. The views expressed may not reflect those of our respective employers.

Quotation permitted provided source is acknowledged.