Quarterly Economic Observer

Autumn 2012

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Nevin Economic Research Institute

About NERI and this publication

The Nevin Economic Research Institute (NERI) has been established to provide information, analysis and economic policy alternatives. Named in honour of Dr Dónal Nevin, scholar, trade unionist and socialist who gave a life of service to the common good, the Institute aims to undertake research that will be of relevance to the Trade Union movement and the general public across the island of Ireland.

This is the third Quarterly Economic Observer (QEO) of the Institute. The purpose of the QEO is to provide regular, accessible and timely commentary so as to equip trade unions and others in articulating and advancing a new economic paradigm where the old has failed. The QEO complements the NERI Autumn 2012 Quarterly Economic Facts (QEF) (NERI, 2012a) which provides a set of statistical indicators to underpin our analysis. The data cited in this Observer are the latest available as of 21 September 2012. The final draft of this document was completed on 24 September.

This report has been prepared by staff of the Institute. The analyses and views expressed in this publication do not necessarily reflect those of the Irish Congress of Trade Unions or the unions supporting the work of the Institute.

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The Nevin Economic Research Institute

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Executive Summary

Following an outline of a five-year fiscal adjustment from 2012 to 2017 in our Summer Quarterly Economic Observer, (NERI 2012b), we focus, in this edition, on the specific details of an alternative budgetary strategy in the Republic of Ireland for the year 2013, only. This is offered in the wider context of on-going public debate in the lead-up to the presentation by the Minister for Finance of next year's Budget in December 2012. The crisis in unemployment continues as the level of real domestic demand stays constant or is in decline. There is evidence of rising income inequality and consistent poverty. Loss of income, jobs and continuing erosion of purchasing power is depressing demand. A succession of austerity budgets is dragging down domestic demand and delaying recovery while exports are not sufficient to generate significant take-off in the immediate foreseeable future. One person's spending is another person's income, business or job and every job creates its own demand for goods and services with a revenue yield for public services.

In our view the priorities for Budget 2013 should be:

- Maintenance of current levels of public capital programme investment;
- direction of additional investment under a new stimulus programme towards priority areas of infrastructure;
- Avoidance of further harm to domestic demand and employment;
- Protection of the incomes of the most economically vulnerable households; and
- Additional and moderate increases in taxation of high-income and high-wealth households.

Specifically, the case is made in this Observer for:

- A prioritisation of public capital expenditure with no further reductions in the planned public capital programme for 2013 and later years;
- A re-assignment of the planned fiscal adjustment towards revenue so that target government expenditure is held at its 2012 level in 2013 (44% of GDP) while target government revenue is pitched at 36.5% - one percentage point higher than what is currently planned;
- A targeted increase in revenue by one percentage point of GDP mainly through a narrowing of tax reliefs and credits for households with incomes in excess of €100,000 per annum; and

- A continuous review of all areas of public expenditure 'line by line' with a view to reducing waste and re-directing savings to additional public spending in priority areas to include for example:
    - Early childhood education and care;
    - Mental health services for young people; and
    - A youth guarantee to extend training and work opportunities for school leavers.

1 Introduction

In the Summer 2012 Quarterly Economic Observer of the Nevin Economic Research Institute (NERI, 2012b) a proposal was outlined for an adjustment in government expenditure and revenue over a period of five years from 2013 to 2017 inclusive.

In this Observer we focus on the details of how fiscal policy in the Republic of Ireland needs to be adapted for 2013 in such a manner as to avoid causing further damage to domestic demand and to ensure greater social and economic equality. The context for this is the continuing unemployment crisis linked to evidence of rising income inequality over time (refer to Table 7.1 in the Appendix).

Recent economic trends in both parts of Ireland are reviewed in Section 2. Section 3 provides an overview of recent macro-economic projections made by various agencies out to 2017 or earlier. In Sections 4 and 5 we explore the details of an alternative budgetary approach in the Republic of Ireland.

The Nevin Economic Research Institute offers this report as a contribution to an important debate. We welcome feedback, comment and suggestions. The precise data used and the specifics of any proposal are subject to review as fresh information and data become available.

2 Overview of Recent Economic Trends

There have been a number of positive economic developments in the Republic of Ireland in recent times:

- Exports – especially from service sectors of the economy – have continued to grow and counter-act some of the negative developments in domestic demand[1];
- A recovery in Gross National Product (GNP) in the second quarter of 2012;
- By contrast with the period 2009-2010 there is evidence of stabilisation in some of the key macro-economic aggregates including the level of Gross Domestic Product (GDP) as well as in the cost of borrowing as reflected in rates of interest payable on loans by the Irish Government; and
- There are signs of higher confidence as reflected in interest yields on 10-year Irish bonds issued on secondary markets.

However, worrying economic signs are given by:

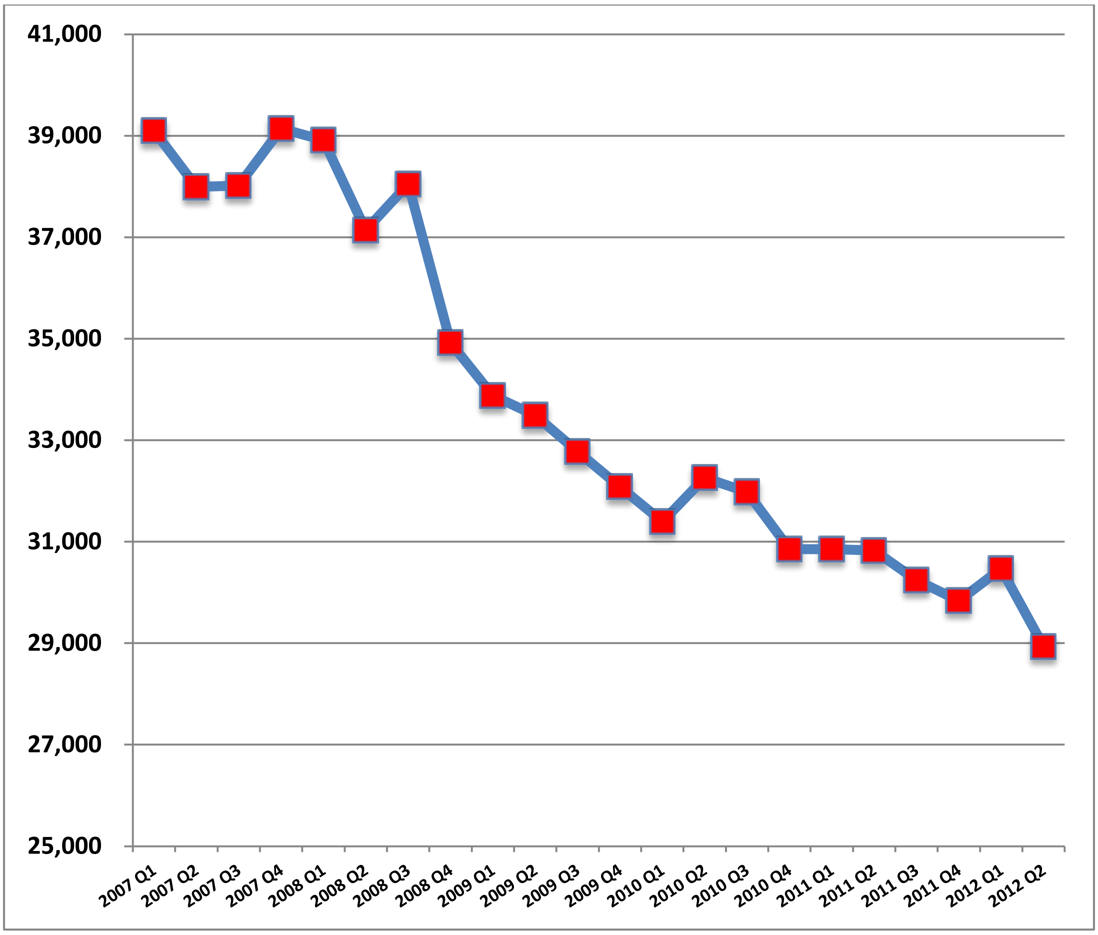
- Continuing high levels of unemployment especially among the young as well as those experiencing long-term unemployment and further distance from participation in paid work;
- A small contraction in Gross Domestic Product in the second quarter compared to the same period last year;
- Evidence of increased economic inequality in 2010 compared to previous years;
- Continuing stagnation in final domestic demand (Chart 1); and
- Signs of dis-improvement in the quality and quantity of some public services with possible immediate and long-term implications for social well-being and general economic competitiveness.

Total employment continues to fall and the rate of unemployment has now reached 14.8% (August 2012). Retail sales across a wide range of goods together with loans to households and businesses continue to contract up to July of this year. The banking sector is still not lending to enterprises as it seeks to repair its balance sheets notwithstanding huge injections of capital by the taxpayer. Total industrial production increased by 6.5% between July 2011 and July 2012. However, production in the

[1] However, provisional data released by the CSO on 20 September 2012 indicate a fall in the volume of exports in the second quarter when seasonally adjusted.

'modern sector' of industry grew by 7.9% of this period and by only 1.9% in the 'traditional sector' pointing to a very different performance in different sectors of the economy.

Chart 1 Trends in the real value of domestic demand (Republic of Ireland) – seasonally addjusted quarterly Data 2007-2012 (€m)



Source: CSO: Quarterly National Accounts.
Notes: Total Domestic Demand = Personal Consumption + Government Consumption + Investment + changes in values of physical stocks. Domestic demand chiefly differs from Gross Domestic Product due to the size of net exports = exports – imports.

Complacency in regard to these economic trends is not justified especially when set against the backdrop of continuing uncertainty globally and among Eurozone economies. The announcement of capital investment proposals by the Government in July 2012 is very welcome. However, the scale, ambition and timing of this stimulus falls well short of what is needed to make an immediate impact on employment not to mention the continuing deficit in key areas of public infrastructure (refer to ICTU, 2012, NERI, 2012c and O'Farrell, 2012). Of particular concern is the way in which any additional investment entailed by this announcement will be combined with on-going reductions in discretionary programme expenditure by Government including the public capital programme. There is a compelling case not only to accelerate investment in priority infrastructure areas but to bring forward plans to reform banking and to establish a Strategic Investment Bank as mentioned in the Programme for Government.

Table 1 Some key economic trends in Ireland and the UK (2007-2011)

		2007	2008	2009	2010	2011
Total Employment	ROI	69.2	67.6	62.2	60.1	59.2
(% of Working Age Population)	NI	68.8	68.2	64.8	66.0	67.1
	UK	71.5	71.5	69.9	69.5	69.5
Unemployment	ROI	4.6	6.3	11.9	13.7	14.4
(% of labour force)	NI	4.1	4.6	6.3	6.9	7.3
	UK	5.3	5.6	7.6	7.8	8.0
GDP	ROI	5.4	-2.1	-5.5	-0. 8	1.4
(% volume change for each year)	NI*	3.0	-2.7	-5.1	0.4	n/a
	UK	3.6	-1.0	-4.0	1.8	0.8

Sources: ROI and UK labour market data refer to the whole year and were taken from the Eurostat Labour Force Survey database.
Northern Ireland labour market data is for the period January to March of each year from the Northern Ireland Labour Force Survey.
GDP data for ROI are taken from CSO National Accounts and UK are from Eurostat National Accounts database.
Northern Ireland Gross Value Added data are taken from ONS Regional Trends Series.

Notes: ROI = Republic of Ireland, NI = Northern Ireland and UK = United Kingdom.
* Northern Ireland output refers to Gross Value Added (GVA).
Total employment refers to all persons in employment (ILO definition) aged 15-64 as a proportion of all persons aged 15-64. Unemployment is calculated on an ILO definition basis and refers to persons aged 15-74.
n/a = not available.

An overview of recent trends in output, employment and unemployment for both Ireland and the United Kingdom is provided in Table 1. Supplementary data may be found in the Annex of this Observer. Following a sharp downturn in 2008 and 2009 recovery in output has been very constrained as unemployment continues to rise. The policies of fiscal austerity in the United Kingdom since 2010 have worsened general economic conditions there. The Republic of Ireland is now in its fifth year of recession or stagnation with no signs of recovery in GDP in the first half of 2012. Serious inroads on the level and rate of unemployment in either jurisdiction are unlikely until sustained growth in output is restored at a rate in excess of 2% per annum.

Too many families and communities continue to experience the triple burden of unemployment, unsustainable personal debt and contracting income whether as a result of on-going ‘reforms’ to social welfare or loss of working hours and real pay cuts as wages fall short of price inflation in many sectors. The position of those dependent on income support such as children, one-parent families, persons with disabilities, the unemployed and pensioners remains extremely precarious and uncertain especially in the context of unrelenting and continuing fiscal austerity into the immediate future and beyond. A recent survey of the Irish League of Credit Unions suggests that one in five adults in Ireland have less than €20 left at the end of the month after meeting bills and essential spending. This proportion rose to 45% with less than €100 left to spend. Many people in these circumstances are extremely worried if there are further changes made to social welfare or income tax. Analysis by Collins, Mac Mahon, Weld and Thornton (2012) has shown that in many households incomes fall short of what would be considered a minimum standard of living. Similarly, research undertaken by Loftus (2012) for the trade union Mandate has shown that a third of its members surveyed reported finding it difficult to feed and clothe their families as well as pay off household debts (Loftus, 2012).

Perhaps nowhere is the threat to social equality and fairness more manifest than in the area of health services where there has been a growing gulf between those able to afford private health up to now and those who are not. There is under-provision and under-financing of key health services such as preventive dental care for children, support for mental health of teenagers and the provision of affordable and cost-effective long-term nursing care for senior citizens to mention only a few areas of acute need and deficiency. The goal of a flourishing Republic where all citizens are cherished equally seems ever more remote as Ireland approaches a number of key centenary events in the next ten years.

It is in this context that recent economic trends and future prospects must be considered. All is not well even if some economic indicators are showing no further contraction at this point. Future economic prospects remain uncertain as will be discussed in the next section.

3 Macro-economic Projections to 2017

Economic forecasting is always beset by the uncertainties of future trends in the behaviour of various economic agents. All forecasters are agreed that the immediate economic outlook remains very uncertain and challenging. Tables 2a and 2b summarises the most recent projections for the economy in the Republic of Ireland. Data for 2011 reflect the last forecast or projection made by various agencies before 1 January 2011. The projections for 2012 and later years come from the latest release of projections by various agencies listed in Table 2a. Typically forecasting agencies project one to three years into the future using relatively informal models to project trends in national income and expenditure. The International Monetary Fund projects out five years to 2017 for the Republic of Ireland. The only other medium-term forecast stretching out over five years is that of Bradley and Untiedt (2012). They have used the HERMIN model to examine different possible pathways out of recession over many years to 2020.

The HERMIN model uses macro-economic data to allow researchers to bring together different production sectors of the economy in a complex model that relates producer, consumer, investor and labour market behaviour to external developments in trade, prices and currency movements. It should be noted that Bradley and Untiedt expect sluggish economic growth and a slow recovery with the prospect of rising unemployment in the short-term and continuing high unemployment for the remainder of the decade. These outcomes are projected on a range of global scenarios from quick economic recovery to a renewed international recession. On the basis of a contractionary fiscal stance for the foreseeable future it is not expected that domestic demand or employment will recover for at least a number of years – even under the assumption of a rapid international recovery. It should also be noted that Bradley and Untiedt do not project a fall in the government deficit below 6% before 2016 – implying non-compliance with current budgetary targets even on the basis of a continuing severe fiscal adjustment.

Our view is that without a significant change in the course of fiscal adjustment in the coming years it is very likely that unemployment will continue to remain high for a prolonged period of time while domestic demand and Gross National Product continue to fall or remain stagnant. The prospect of a dual economic outcome opens up characterised, on the one hand, by rising exports, a relatively vibrant modern trading sector and limited progress in regard to budgetary targets, and on the one other hand, by diminution in the size of the State and public services with falling real wages throughout most of the economy and a continuing high level of unemployment and under-employment with the risk of increased levels of income inequality and poverty. One of the consequences of latter developments is that these will place a brake on the effectiveness of fiscal adjustment as expenditures related to unemployment and high income coupled with depressed revenue buoyancy blunts the impact of any given fiscal consolidation.

Table 2a Overview of recent projections of change in real GDP (Republic of Ireland)

	2010	2011	2012	2013	2014	2015	2016	2017
Outcomes	**-0.4**	**1.4**						
Department of Finance	-1.3	1.7	0.7	2.2	3.0	3.0	-	-
Central Bank	-2.3	2.4	0.7	1.9	-	-	-	-
EU Commission	-1.4	0.9	0.4	1.4	2.8	2.8	-	-
Internat. Monetary Fund	-2.5	2.3	0.4	1.4	2.5	2.8	2.8	2.9
OECD	-2.3	1.5	0.6	2.1	-	-	-	-
ESRI (QEC)	-0.25	2.25	1.8	2.1	-	-	-	-
Ernst and Young	-0.6	1.1	-0.1	0.6	1.4	3.0	-	-
NCB	-0.3	1.0	0.3	1.7	2.0	2.2	-	-

Sources: Department of Finance Stability Programme Update (April 2012) (Department of Finance, 2012a); Central Bank: Quarterly Bulletin (July 2012); European Commission (September 2012); International Monetary Fund: Seventh Review Under the Extended Arrangement (September, International Monetary Fund, 2012a); OECD: Economic Outlook (May 2012); ESRI: Quarterly Economic Commentary (September 2012) (Duffy, Durkan and Casey, 2012); Ernst and Young: Economic Eye, June (2012); NCB: Irish Economy Monitor (June 2012).

Notes: Data sources for Outcomes: Central Statistics Office and Eurostat.
Previous forecasts for 2010-2011: Forecasts made at the end of the previous year (2009 and 2010, respectively, for 2010 and 2011)
Current forecasts for 2012-2014 as of September 2012 or the most recent period.

Table 2b Overview of recent projections of unemployment as % labour force (Republic of Ireland)

	2010	2011	2012	2013	2014	2015	2016	2017
Outcomes	**13.7**	**14.4**						
Department of Finance	13.2	13.2	14.3	13.6	12.8	11.7	-	-
Central Bank	14.0	13.3	14.7	14.4	-	-	-	-
EU Commission	14.0	13.5	14.8	14.4	13.7	13.1	-	-
IMF	15.5	13.0	14.8	14.4	13.7	13.1	11.5	10.6
OECD	14.0	13.6	14.5	14.4	-	-	-	-
ESRI (QEC)	13.75	13.5	14.8	14.6	-	-	-	-
Ernst and Young	13.2	12.7	14.9	15.2	15.1	14.4	-	-
NCB	13.0	13.0	14.2	13.6	12.4	10.5	-	-

Sources: See table 2a.
Notes: See table 2a.

Table 2c provides an overview of recent economic forecasts for the Northern Ireland economy. Growth in Gross Value Added (the nearest proxy to GDP) is expected to remain sluggish for the remainder of this year and marginally recover next year. According to forecasts by Ernst and Young the rate of unemployment is expected to increase and remain above its current level of 8% until 2015.

Table 2c Overview of recent projections of real gross value added (GVA) and unemployment (Northern Ireland)

	2011	2012	2013	2014	2015
Gross Value Added					
Ernst & Young	0.3	0.1	1.0	2.1	2.1
PWC	0.8	0	1.7	-	-
Oxford Economics		0.3	1.5	-	-
Unemployment % Labour Force					
Ernst & Young	7.4	8.1	9.0	9.2	9.1
Oxford Economics	-	7.8	-	-	-

Sources: Ernst and Young: Economic Eye Summer 2012; PWC: Economic Outlook August (2012); Northern Bank/Oxford Economics: NB Quarterly Economic Overview Q2 2012.
Notes: Gross Value Added differs from GDP by the difference between taxes and government subsidies.

4 Maintaining Levels of Public Service

4.1 Political and Economic Constraints

Political economy explores choices and allows for a complex interaction of economic agents. Public finances sit within a large economic and social context. Regulating public finances can never be a simple exercise in accountancy. It must allow for the dynamic relationship between government and the rest of the economic world. At the European level it is widely believed and asserted that the only way to balance the public finance books is through a combination of discretionary cuts to public spending and increases in taxes. While acknowledged, the role of economic growth – and even price inflation – is frequently overlooked as key to sustainable public finances in the long-run whether through currency value changes or the natural tendency for increasing prices to erode the real value of debt. Historical experience confirms this.

Discretionary changes are needed – however the scale, timing and composition of these changes must refer to a broader picture of the economy and the role of public finances as an agent for facilitating a recovery while protecting social cohesion and social equity. In the context of a relatively small and extremely open economy such as the Republic of Ireland, and one that is now locked into a special international lending arrangement with policy conditionality, it is often asserted that the scope for a domestic policy initiative especially one that might involve a significant fiscal stimulus is severely limited and, in any case, largely ineffective due to high import leakage given Ireland's trade openness. Indeed, the continuing hole in public finances (with government borrowing equivalent to over 8% of GDP) is cited as evidence of an on-going fiscal stimulus in its own impact.

The limitations on the effectiveness of domestic fiscal policy together with the extent to which public policy is constrained is undoubtedly an important consideration. However, these factors can be exaggerated or misunderstood especially in regard to:

- The scope for domestic choice in regard to the overall level of public finances and revenue both now and in the medium-term (as distinct from the difference between the two which gives the government deficit); and
- The potential for avoiding further harm to domestic demand by further fiscal contraction in an already-depressed economy.

A wise and prudent approach to fiscal adjustment involves timing, priority, justice and vision – informed by what quality of public service and social protection we envisage in the long-term. Fiscal rules and targets are necessary and desirable. However, they need to be integrated with a larger set of social and economic goals compatible with moving towards full employment and removal of poverty. Poverty and unemployment stand in the way of fiscal balance and the more government seek to balance the books the more economic recovery is impeded or delayed. We propose a range of flexible fiscal targets that take account of the economic cycle as well as the state of an economy in regard to unemployment, the level of public services and the structure of revenue and expenditure. Given Ireland's low rate of government revenue (refer to indicator 7.2 in Quarterly Economic Facts – NERI, 2012a) we propose that a fiscal target close to European norms be set and that revenue be adjusted gradually upwards to close the gap between spending and receipts as Ireland moves out of recession in the coming years. The forthcoming Fiscal Responsibility legislation, here, should reflect this.

It is not possible or politically realistic for Government to 'balance' its own books while fundamental imbalances prevail in the rest of the economy. In a previous Observer (NERI, 2012c) we pointed to the symmetry between imbalances in domestic savings, investment and trade summarised in the accounting identity where a deficit in public finances (an excess of spending over revenue receipts) must equal the sum of net payments on balance of payments current account and net domestic private savings. Attempts by many Governments across Europe to force a balance in public finances in the midst of the greatest world recession since the 1930s are likely to prolong stagnation and undermine recovery in consumption and investment. The experience of the international response to the crisis particularly since 2010 has underlined this point.

4.2 Aiming for European Norms of Spending

In the Summer Observer, we have made the case for holding the present level of public spending as a percentage of GDP as close as possible to the current European average level of over 45%. We propose a flexible fiscal rule target of 44% for overall public spending in 2013 including interest payments on general government debt. This target is related to a projected growth in GDP of approximately 1 to 2% in 2013 reflected in the forecasts of the Department of Finance. In the event that a severe world recession might lead to a contraction in GDP in Ireland in 2013 (scenario 3 in Bradley and

Untiedt, 2012) some upward flexibility in public expenditure should be envisaged to allow for unexpected demands on social spending. A target range of 43-45% would be appropriate within a range of GDP growth forecasts. It should be noted that an overall spend of 44% in 2013 would include approximately 5.6% of GDP for payment of interest on debt service leaving only 38.4% for 'primary expenditure' (current and capital spending less interest payments on general government debt). A level of primary expenditure of 38% is low by EU and OECD standards.

4.3 Cuts and Savings

Fiscal adjustment is often discussed as if cuts in public expenditure and increases in tax translate immediately and entirely into 'savings' which lower the government deficit. In any year there is a significant 'carry-over' effect on both spending and revenue and we estimate that the carry-over of Budget 2012 revenue and spending impacts are €220 million and €700 million respectively (in other words the full-year effect of decisions made in Budget 2012 will not be realised until 2013). It is also the case that any given adjustment, for example, a cut of one billion Euro in public spending will impact on revenue through a number of channels:

- Lower income, USC and PRSI receipts where employment is lost;
- Lower VAT and excise receipts where consumption is lower; and
- Other revenue losses over time as lower domestic demand feeds its way through domestic economic activity.

Modelling simulations used by Bergin, Conefrey, Fitzgerald and Kearney (2010) point towards a likely negative impact on GDP of somewhere in the region of 0.4-0.5% for every €1 billion in fiscal adjustment (=0.6% of GDP) in the first year. For example a cut of €1bn (=0.6% of GDP) arising from lower public sector employment lowers GDP by between 0.8% and 0.9% in the first four years following the adjustment. A cut of €1 billion in capital spending lowers GDP by 0.1-0.3% (with the proviso that this is likely to be an under-estimate as supply-side impacts are not accounted for[2]). A cut of €1 billion in public sector wage rates would lower GDP by between 0.2-0.3%. A similar overall negative impact is likely for the same level of adjustment on the revenue side.

[2] Bergin, Conefrey, Fitzgerald and Kearney (2010) state that: 'These simulations do not take account of the significant positive supply side effects from public investment'

All of these estimates are based on static conditions with regard to markets and credit conditions and reflect pre-2008 relationships.

An aspect of the public debate leading up to the budget each year is the consideration of statistical information on various areas of public finance. It would greatly help users of information and participants in the debate about budgetary choices if more timely and comprehensive information were made available. We concur with the view of the Irish Fiscal Advisory Council (IFAC, 2012:22) expressed as follows:

> *The Council, therefore, urges the Department [of Finance] to make available publicly and in a timely manner comprehensive details of any changes that significantly affect the official forecasts.*

4.4 Current Policy (Plan A)

The context for an alternative budgetary strategy is the current policy plan. We refer to this as 'Plan A'. The Irish Fiscal Advisory Council along with other economic commentators including the Central Bank, Department of Finance and the ESRI as well as international agencies including those that form the 'Troika' are agreed that significant further discretionary cuts in spending are unavoidable and necessary. For example, IFAC (2012:39) has stated that:

> *At a more disaggregated level, the SPU [Stability Programme Update] projections show the need for significant real expenditure reductions in all main categories, notwithstanding underlying spending pressures. Given the extent of the required total adjustment, the Council again urges that all adjustment margins be kept under close review, including tax rates, public-sector pay and pensions and welfare rates.*

Plan A rests very explicitly on the unquestioned assumption or interpretation of the international literature that spending cuts are to be preferred to tax increases when aiming for fiscal correction. Implicitly, there is near universal acceptance that the total share of public expenditure as a proportion of national income must decline. On this basis, discussion of budgetary choices is kept within a narrow and tight set of assumed constraints. As we will show later there is an alternative to this adjustment pathway. The evidence in regard to cuts versus taxes is inconclusive. Work by Alesina and other economists is often cited in support of a cuts policy over taxes. However, a review by the IMF Fiscal Monitor (International Monetary Fund, 2012b) of fiscal multipliers found a more positive growth impact of tax measures over expenditure. Modelling using HERMIN also suggest more positive impacts in the short-run from revenue measures (Healy and O'Farrell, 2012 forthcoming).

Table 3 shows planned discretionary reductions to current and capital expenditure over the next three years. A discretionary expenditure decision is one which involves a change to payment rates or programme eligibility or access. A non-discretionary expenditure change occurs when as a result of changes in unemployment, household income or interest payments on general debt additional or less public expenditure is incurred. Unemployment is a major driver of non-discretionary expenditure since for given rates of payment and eligibility to various supports, expenditure rises (falls) when unemployment increases (decreases).

In total, a cumulative reduction of €5.85 billion is planned in discretionary expenditure cuts in the course of the next three years. This plan is predicated on what may now be regarded as optimistic forecasts of growth in GDP at least in the immediate two years ahead – 2013-2014. The vast bulk of the planned cut of €5.85 billion is made of planned cuts to current spending (€5.2 billion) in the three Budgets for 2013, 2014 and 2015.

Table 3 Medium-Term fiscal discretionary adjustments €billion (Plan A)

	2013	2014	2015
Current	1.70	1.90	1.30
Capital	0.55	0.10	0.00
Total Expenditure	**2.25**	**2.00**	**1.30**
Total Revenue	**1.25**	**1.1**	**0.7**
Overall Total	**3.5**	**3.1**	**2.0**

Source: Comprehensive Expenditure Review (Department of Public Expenditure and Reform, 2011).

Table 4 provides an overview of the main expenditure headings indicated by the Department of Finance last April in its Stability Update Programme. Plan A envisages a sharp contraction in the amount of public spending devoted to public current and capital services excluding interest payments on debt. Non-interest payment spending is referred to as 'primary expenditure'. Primary expenditure is set to fall from 40% in 2012 to 33.2% in 2015 placing Ireland firmly at the bottom of the international league of countries in terms of primary public expenditure for services and social supports.

This would represent a major shift in the overall size of the State and its impact on employment, incomes and social equality – the full implications of which have not been adequately explored or spelt out in the documentation supporting fiscal reviews.

Table 4 Projected general government revenue and expenditure (Plan A) % GDP

		2012	2013	2014	2015
A	Total Expenditure	44.1	43.5	40.8	38.8
B	Total Revenue	35.8	35.9	36.1	36.0
C=A-B	Borrowing (Government Deficit)	-8.3	-7.5	-4.8	-2.8
D	Interest on debt (included in total expenditure above)	4.1	5.6	5.5	5.6
A-D	Primary Expenditure (expenditure less interest payments)	40.0	37.9	35.3	33.2
	Components of primary expenditure				
	Staff compensation	11.5	10.9	10.3	9.7
	Social transfers	17.3	16.5	15.3	14.5
	Other current spending	5.2	4.9	4.5	4.2
	Public capital spending	2.5	2.3	2.1	2.0
	Not classified above	3.5	3.3	3.0	2.9

Source: Stability Programme Update. Page 49. Table A1. (Department of Finance, 2012a).

If adhered to, the current fiscal adjustment foreseen in plans to reduce spending as a percentage of GDP from approximately 44 to 39% of GDP over the next three budgets, will have a profound impact of public services especially in areas of continuing high demand such as education, health and social protection. It is possible that projections of future spending needs have been under-estimated due to the likelihood of continuing high unemployment and associated costs.

4.5 An Alternative Approach (Plan B)

An alternative adjustment pathway as outlined in our last Observer (Summer 2012) would entail holding the overall level of public spending at about the current 2012 level while raising government revenue from its current level of 35% to narrow the government deficit over time. We focus, here on the next year, only, where a target government deficit of 7.5% of GDP has been agreed with the Troika. We accept this figure as a working target for the coming year although it could be significantly affected by a sharp economic downturn or by a fresh bank recapitalisation. The Department of Finance (2011:43) has estimated how a lower annual GDP growth impacts on the General Government Balance (the government deficit). For example, a lower growth in GDP in 2012 by one percentage point would raise the Balance from -8.6 to -9.1% of GDP.

Raise revenue and hold expenditure at its current level as % of GDP

A re-balancing of planned fiscal adjustment in 2013 away from spending to revenue would have a different impact on GDP, employment and the Government deficit itself. Using the HERMIN model we have modelled an adjustment in Budget 2013 together with a special 'off-the-books' investment stimulus of €500 million in 2013 brought forward from the July investment announcement by Government. This would involve holding overall spending at 44% of GDP (or €73.3 billion) and raising revenue to 36.5% of GDP (or €60.8 billion). Allowing for the impact of any given adjustment we have modelled the impact on GDP and other variables to estimate the impact on the final value of GDP, Government Expenditure and Government Revenue in 2013[3].

The impact of Plan B on GDP, employment and government deficit

Taking the Department of Finance forecast for 2013 as a given (2.2% growth in the volume of GDP) we have used the HERMIN model to estimate the likely impact of a gross fiscal adjustment of €3.5 billion in Budget 2013. An ex-ante fiscal adjustment is a combination of changes to expenditures and revenue before any feedback as a result of changes in economic behaviour arising from these changes. An ex-post fiscal adjustment represents the change in expenditure and revenue as a proportion of GDP once these changes have taken place. We estimate that, under Plan A, an ex-ante cut in expenditure by €2.25 billion, of which €550 million would be from capital investment, and a raising of revenue by €1.25 billion would lower GDP growth by 1.9% of GDP and employment by 29,000 in 2013.

Alternatively, under Plan B, we propose:

– Cancellation of planned cuts in public capital spending (€550 million in 2013)

[3] Further details of the underlying work will be available in a paper to be presented to the Dublin Economics Workshop - Healy and O'Farrell (2012 forthcoming).

- Cancellation of planned cuts in public current spending amounting to €1,300 billion leaving savings of around €400 million through the 'Croke Park Agreement'[4].
- Additional revenue measures yielding €2.3 billion in a full year including the carry-over of €300million already arising from Budget 2012.

Reductions of €700 million would arise as a result of falling public sector employee numbers as well as savings in other areas such as, for example, in health with the use of generic drugs which are much cheaper.

Table 5 Fiscal adjustments under Plan A and Plan B in 2013

Plan A	Ex-ante adjustment €bn	Ex-post adjustment €bn	Net adjustment % GDP
Current spending	*-1.70*		-
Capital spending	*-0.55*		-
Reduced Expenditure	**-2.25**	+1.25	-0.6
Additional Revenue	**+1.25**	+2.10	+0.1
Total consolidation*	**3.5**	-	-

Plan B	Ex-ante adjustment €bn	Ex-post adjustment €bn	Net adjustment % GDP
Current spending	*-0.4*		-
Capital spending	*0*		-
Reduced Expenditure	-0.4	+3.1	-0.1
Additional Revenue	+2.3	+3.8	+0.7
Total consolidation*	**2.7**	-	-

Notes: Ex-ante adjustment represents the total value of changes to expenditure or revenue as a result of discretionary changes to payment rates or eligibility to services or tax liability.
Ex-post adjustment represents the change in the percentage of GDP accounted for by expenditure or revenue after account is taken of discretionary changes, revenue buoyancy, non-discretionary variations in spending (e.g. lower unemployment) and changes arising from demand for public services driven by demography and other factors.
* Total fiscal consolidation is the sum of revenue changes and expenditure changes regardless of the sign on the constituent numbers.

Outcomes of Plans A and B compared

Table 6 summarises the results on the basis of:

(A) no change in current policy plans for 2013 (in other words discretionary cuts of €2.25 billion and revenue increases of €1.25 billion);

(B) no further reduction in the ratio of overall public spending to GDP combined with an increase in the ratio of Government Revenue to GDP to bring the total to €60.8 billion or 36.5% of GDP in 2013 after allowance is made for the positive impact on

[4] The Public Service Agreement, 2010-2014.

GDP of a 'Plan B' fiscal adjustment coupled with an investment stimulus. As part of an alternative fiscal adjustment we envisage no further cuts in the public capital programme (thus keeping capital spending at least at the already depressed 2012 level) and an additional €500 million in additional 'off-balance' sheet capital expenditure by a mix of public and private sources[5].

Table 6 Two fiscal adjustments compared (2013)

	Baseline (2012)	Baseline (2013)	Plan A (2013)	Plan B (2013)
GDP nominal values (€bn)	158.9	168.4	164.2	166.5
Employment ('000s)	1,803	1,846	1,817	1,838
Unemployment rate (% Labour Force)	14.3	12.3	13.6	12.6
General Government Balance (% GDP)	-8.3	-8.6	-7.5	-7.5
Government Expenditure	44.1	44.0	43.5	44.0
Government Revenue	35.8	35.4	35.9	36.5

Notes: Baseline corresponds to the actual estimated outcome in 2012 and in 2013 without any fiscal adjustment whatsoever.
Plan A entails an adjustment of €3.5 billion of which €2.25 billion is from expenditure
Plan B entails an adjustment of €2.7 billion of which €2.3 bn is accounted for by revenue.

Table 7 Plan B would be good for growth and jobs

	Plan A relative to baseline	Plan B relative to Plan A
GDP real growth rate difference	-1.9%	+1.3%
Employment	-29,000	+21,000
Unemployment rate (% Labour Force)	+1.3%	-1.0%
General Government Balance (% GDP)	+0.3%	0.0%
Government Expenditure difference	-€2.659bn	+€1.841bn
Government Revenue difference	-€658bn	+€1.831bn

Notes: See notes to Table 6 above.
Under Plan A GDP is lower by 1.9% and unemployment is higher and these factors in combination with others lead to higher expenditure and lower revenue than under the baseline scenario.

There is no difference in outcomes between Plan A and Plan B in 2013 with regard to the government deficit and overall level of gross debt expressed as a percentage of GDP. The key difference is the targeted level of 'primary public expenditure' as a percentage of GDP. Under Plan A the intention is to reduce the level of primary public spending from an estimated 40.0% in 2012 to 37.9% of GDP – a drop of 2.1 percentage points or, approximately, €1.5 billion in total primary expenditure.

[5] It is sometimes assumed that off-balance sheet funding of capital projects can only be undertaken by means of a public-private partnership arrangement. This is not the case as Eurostat rules for the measurement of government debt and deficits allows for, among other things, borrowing by commercial public enterprises for projects that involve a benefit and cost flow with revenue arising from sales of a product or service over time.

Under Plan B the proposal is to reduce the level of primary public spending as a proportion of GDP by a smaller magnitude – a drop of 1.6 percentage points - from 40.0% in 2010 down to 38.4%. The wedge between overall target spending at 44.0% in 2013 and total primary spending is total payments of interest on general government debt projected for 2013 (5.5%[6]). This latter amount is similar under both Plans A and B. In the event of an agreement at European Union level to reduce the interest payment burden it would be possible to reduce the total interest by up to one percentage point (lowering the interest bill from 5.6% of GDP to approximately 4.6% in 2013). In this event we would concur with a much smaller contraction in primary spending as a proportion of GDP. Given the positive impact of an ambitious investment programme it should be possible to conserve the real value of primary expenditure including current and capital voted exchequer expenditure and direct savings arising from lower unemployment to priority areas.

Increasing public spending in areas of critical social need

A ‘no further overall cuts’ stance such as proposed in Plan B does not mean that savings could not be made across a range of programmes. We support a rigorous, continuous and in-depth investigation of every area of public spending with a view to achieving cost reductions where these are possible and desirable on economic and social grounds. The results of a periodic review of spending such as are summarised in the Comprehensive Review of Expenditure and published in December 2011 (Department of Public Expenditure and Reform, 2011) should be made available along with the detailed and unedited briefing material prepared by each Department. Where savings can be achieved in various areas the amount realised should be diverted into priority areas of public support. Mention here is made of the following three areas in particular where Ireland needs to catch up on many other European countries and where the benefits are likely to be significant:

- Investment in early childhood education and care;
- Mental health services for young people; and
- A youth guarantee to extend training and work opportunities for school leavers.

[6] After adjustment for higher GDP due to a Plan B fiscal package.

5 Paying for Public Services

5.1 Introduction

Ireland continues to be a low-tax economy. As a proportion of Gross Domestic Product Government raises less in various types of taxes combined than most other European countries. Even if Gross National Product were to be used for comparison there is still a shortfall in revenue because much of the difference between GDP and GNP is in the form of corporation profits which are repatriated abroad and are still subject to tax in this jurisdiction albeit at a very reduced rate[7].

At European level there is a strong case for a coordinated approach to tax including tax on capital, financial transactions and corporate income. Recently, a number of German economists have argued for a once-off levy on wealth as a means of addressing the severe public debt overhang in European countries (Bach, Beznoska and Steiner, 2011 and Bach, 2012). It is worth considering the matter at this time especially at a European level where joined up thinking and policy response needs to be coordinated to make such a levy effective.

A further fiscal consolidation of at least €3.5 billion has been signalled by the parties to the Troika Agreement (Department of Finance, 2012b) of which €1.25 billion has been earmarked for additional revenue. The components of this adjustment have been signalled as follows:

- A broadening of personal income tax
- A value-based property tax
- A re-structuring of motor taxation
- A reduction in general tax expenditure
- An increase in excise duty and other indirect taxes.

The above list provides headings for Government stated intentions under each heading rather than details of how much could be raised under each heading.

[7] International comparisons of public expenditure are complicated in the case of Ireland due to the large gap between GNP and GDP resulting from large net outward factor income flows. We will return to this issue in future editions of the Observer. We regard GDP as the most meaningful measure of the total taxable amount of income and production in the country in a year. While it is the case that the effective or average tax rate on net factor income flows is lower than for the rest of domestic economic activity, all of GDP is taxable and remains relevant to a consideration of the total amount of income liable for tax (see Collins, 2011 and Bristow, 2004).

We propose a different menu of revenue adjustments as well as a higher overall revenue take which would bring total Government Revenue to a target level of 36.5% instead of the (revised) target of 35.9% according to the latest set of targets published by the Department of Finance in April 2012 (Stability Programme Update (SPU)). So, we are proposing in the region of an additional €1billion on top of the figure of €1.25 billion already signalled to bring the targeted additional revenue in 2013 to €2.25 billion. This sum includes a carry-over of €300 million in revenue arising from Budget 2012 as indicated in the April 2012 SPU.

Additional revenue arising from higher effective income tax rates, reforms to the tax system and a broadening of the tax base are detailed in Table 8. The guiding principles are:

- Simplification of the tax code and avoidance of multiple reliefs, exemptions and distinctions between types of tax payers and categories of income and wealth.
- Fairness where those best able to pay are subject to higher rates of tax.
- A better rationale for the different ways in which income from work or social transfers, consumption and assets are taxed.

As part of our proposals for Budget 2013 we suggest that Government pays greater attention to the additional revenue that can be raised from reforms to the income taxation system. In particular, there is obvious potential to increase the average tax rate of households at the top of the income distribution; a reform that would generate substantial extra tax revenue. In this Section we discuss a number of options for increasing revenue which would incorporate increases already planned.

Table 8 Sources of additional government revenue (2013) including increases already indicated.

Sources	€ m
Already proposed by Government	
Increases already signalled by Government	€925
Carryover from tax changes in Budget 2012	€300
	€1,250
Proposed by NERI	
Increases in income taxes for high earners	€650
Wealth tax	€200
Capital Gains and Acquisition Tax reforms*	€100
Corporation Tax reforms	€50
Site Value Tax**	(€300)
	€1,000
Overall Total	**€2,250**

Notes: * Estimated yield.
** Government has already signalled the introduction of a property tax in Budget 2013 and this revenue is included in the figure above. We propose that this should be a site value tax and detail the proposal later in this section.

Given a likely increase in informal activity not reported in national statistics and not within the tax net since the onset of recession there is a strong case for reinforcing the resources of the Revenue Commissioners to address short-falls in revenue arising from illegal activities. A recent report of Retail Ireland (2012) highlight the problem of illegal smuggling and laundering of goods as well as illegal downloading of products. It acknowledges the shortfall in revenue staff numbers is a constraint.

5.2 Personal Income Tax

Accessing up-to-date data on the structure of Ireland's income distribution, and the amounts of taxation paid by earners and households, is challenging. The most recent *Revenue Commissioner Statistical Report* is for the calendar year ended December 31st 2010 and reports information for tax cases rather than individuals or households (Revenue Commissioners, 2012). A more detailed insight, albeit also with data from 2010, is available from the most recent CSO *Survey on Income and Living Conditions* (SILC) published in March 2012. SILC collects data on individual and household income from all sources (employment, social welfare, pensions, investment returns etc) alongside information on the amount of income taxation paid by households.[8]

An alternative source of information on the distribution of income tax paid is from responses provided by the Minister for Finance to Parliamentary Questions. The latest information is summarised in Table 9. Data refer to the most recently available information –2012 and have been calculated by the Revenue Commissioners using the Tax Forecasting Model anchored on 2009 data and updated for changes in subsequent budgets.

Table 9 Distribution of income tax paid by 'tax cases' – estimated position in 2012

	Top 1%	Top 10%	Top 20%
Number of 'tax cases'	21,650	216,500	433,000
Gross Income	€8,742 m	€29,600 m	€43,300 m
Average earnings	€403,760	€136,710	€100,000
Amount of income tax	€2.5 bn	€7.1 bn	€9.3 bn
Effective tax rate	28.60%	23.99%	21.48%

Source: Parliamentary Question 317445/12 (3 July 2012)

Note: The figures for tax and effective tax rate only relates to income tax and do not take account of additional liability to PRSI and the Universal Social Charge. The figures are estimates from the Revenue tax-forecasting model using actual data for the year 2009 adjusted as necessary for income and employment trends in the interim. Gross Income is as defined in the Revenue Statistical Report 2010 (Revenue Commissioners, 2012). A married couple who has elected or has been deemed to have elected for joint assessment is counted as one tax unit.

Table 9 reflects the fact that taxpayers with the highest incomes in the country pay a much smaller proportion of their income in income tax than many suspect. Even among the top 10,000 income tax cases, approximately the top ½%, the effective tax rate rises to only 29%.[9] Consequently, the table also suggests that there is potential for Government to increase the income tax take from the highest earners in Irish society.

We propose a modest increase in the effective income taxation rate faced by the top 20% of tax cases. Overall we suggest that the effective income tax paid by this group rises by 1.5% in 2013; meaning that on average the top 20% of tax cases would pay almost 23% of their income in income taxation in 2011.

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[8] A forthcoming NERI research paper uses this data to examine the nature of income taxation in Ireland - See Collins (2012) *Income Taxation in Ireland: Profiles and Policy Options*.

[9] See Parliamentary Question 317442/12 (3 July 2012).

Table 10 Revenue impact of an increase of 1.5% on the effective tax rate of the top 20% of tax cases

	Top 20%
Number of 'tax cases'	433,000
Gross Income	€43,300m
Average earnings	€100,000
Amount of income tax	€9.3bn
Effective tax rate	21.48%
Increased Effective tax rate	22.98%
Additional tax revenue	€650m

Reforming the income taxation system in this way would, based on the Revenue Commissioners data, generate an additional €650 million in income taxation revenue in 2013. It's impact on the top 20% of tax cases would be to see their income taxation bills increases by an average of:

- €1,500 per annum for the top 20% of tax cases;
- €2,000 per annum for the top 10% of tax cases; and
- €6,000 per annum for the top 1% of tax cases.

Table 11 calculates the impact that this would have on two example high earning households within the top 20% of tax cases and includes in its calculations the PRSI and USC paid by the households. Following such a reform, a household on an income of €120,000 would pay a total of 34.69% of its income in income taxes, PRSI and the USC. Its disposable income would fall by €1,800 per annum from €79,866 to €76,266.

Table 11: Impact on overall average tax rates and disposable income of increase in effective income taxation rates

Tax Case Description	2012	2013 with reform
Couple 2 earners on an income of €100,000		
Income tax (after credits)	€20,624.00	€20,624.00
Additional income tax of 1.5% in 2013	-	+€1,500.00
USC	€5,637.60	€5,637.60
PRSI	€3,471.68	€3,471.68
Total Income tax + USC + PRSI	€29,733.28	€31,233.28
Effective income tax rate	20.62%	22.12%
Effective overall tax rate (Income tax + PRSI + USC)	29.73%	31.23%
Disposable income	***€70,266.72***	***€68,766.72***
Couple 2 earners on an income of €120,000		
Income tax (after credits)	€28,824.00	€28,824.00
Additional income tax of 1.5% in 2013	-	+€1,800.00
USC	€7,037.60	€7,037.60
PRSI	€4,271.68	€4,271.68
Total Income tax + USC + PRSI	€40,133.28	€41,933.28
Effective income tax rate	24.02%	25.52%
Effective overall tax rate (Income tax + PRSI + USC)	33.44%	34.94%
Disposable income	***€79,866.72***	***€76,266.72***

Notes: Calculations assume a 65%:35% income split between couple and couples are assessed either individually or jointly depending on which option minimises their tax liability. The analysis ignores other possible tax reducing options such as pension contribution and AVCs to pension savings, tax free lump-sum payments, losses carried-forward, education fees relief, health expenses relief, flat rate expenses and other tax expenditures. The calculations also assume no change in the structure of PRSI and USC between 2012 and 2013.

Achieving these increases in average income tax rates is a choice for Government and Budgetary policy. However, a number of options are open. These include reforming the structure of tax credits so that they reduce as income increase and are fully 'recaptured' for high earners - Collins and Walsh (2010) outlined a proposal for how such a policy might operate for high earning individuals. Other options include a more progressive structure for the USC with a series of higher rates for higher incomes. Similarly, additional reforms should be introduced in Budget 2013 to ensure a minimum effective rate of tax on all incomes above €100,000 per annum. A limit should be placed on the use of specified tax reliefs and exemptions by high earners. Further changes in the marginal rate of tax (which currently is at 52% when maximum USC and PRSI rates are included) are not proposed. However, as indicated below, PRSI and USC should be extended to types of income including capital gains above a certain low income threshold.

5.3 Wealth and Assets (including inheritance and capital gains)

5.3.1 Wealth Tax

The main components of tangible wealth are financial assets, residential buildings, other buildings, land and other tangible assets such as valuable private goods. Various forms of intangible wealth such as human capital (the value of human skills and ability), reputation capital in organisations and enterprises and social capital (the value of social networks in various types of communities) represent very important forms of wealth to individuals and households and are likely to yield a significant economic return over a lifetime. However, for the purposes of identifying wealth and assets which can be taxed we discuss, here, only tangible wealth as listed above.

Relative to income, little is known about the scale and distribution of wealth in the Republic of Ireland. Attempts have been made by some agencies to estimate the total amount of financial and other wealth (Central Bank, 2012, Bank of Ireland, 2007 and Credit Suisse, 2011). Some researchers have attempted to extrapolate from international data to estimate the possible or likely distribution of wealth in Ireland (Credit Suisse, 2011). The latter have estimated that wealth in the Republic of Ireland is heavily concentrated as elsewhere in the world with an estimated 1% of the adult population owning 28% of total wealth (financial and non-financial), 5% of owning 47% and 10% owning 59% (Credit Suisse, 2011:146). Whatever about the reliability of any estimate for the Republic of Ireland – given the absence of wealth distribution data – such an estimate is not out of line with the pattern in many other European countries. Based on international evidence it is likely that wealth is more unevenly distributed than income.

Estimates of wealth (financial, land and buildings) in the United Kingdom by HM Revenue and Customs indicates that the top wealth decile owned about 44% of total wealth in 2007[10]. This contrasts with an estimate of 52% for the United Kingdom in 2011 (Credit Suisse, 2011:146). If this pattern were replicated in the Republic of Ireland it would point towards a very unequal distribution of wealth – financial and non-financial.

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[10] HM Revenue and Customs. http://www.hmrc.gov.uk/stats/personal_wealth/menu.htm

It is certain that the total current market value of residential and other property components of wealth have depreciated sharply in since 2008 and this has been reflected in a sharp deterioration in the value of property assets owned by households (see Cussen and Phelan, 2011). The value of net financial assets held by residents in the household sector have been less impacted. The most recent Central Bank data indicate a figure of just under €120 billion in net financial assets held by residents in households in Ireland (Central Bank online database).

A number of OECD countries including France, Norway and Switzerland levy taxes on wealth as a stock of monetary value as well as taxes on income or consumption as flows of monetary value. As a percentage of GDP the total collected was, in 2010, 1.3%, 0.57% and 0.23% respectively for Switzerland, Norway and France. In the case of Luxembourg the tax is on the wealth of corporations and it yielded 2.1% of GDP. Historical data produced by the OECD[11] show that the yield from the wealth tax introduced in the Republic of Ireland in 1975 was at its highest in 1976 at 0.127% of GDP. In today's value of GDP this would be equivalent to a yield of just over €200 million.

Typically rates of taxation on the stock of wealth are modest (1 or 2% per annum) reflecting the need to strike a balance between maintaining the overall value of assets still held privately and the cash flow required by owners to pay an annual tax. Also, a significant threshold before tax is liable is not uncommon. Recently, a number of German economists have argued for a once-off levy on wealth as a means of addressing the severe public debt overhang in European countries (Bach, Beznoska and Steiner, 2011 and Bach, 2012). The history of one-off emergency capital levies (or compulsory loans by the private to the public sector) has been reviewed by Eichengreen (1989). The imposition of once-off levies has met with mixed success historically. Nevertheless it is worth considering the matter at this time especially at a European level where joined up thinking and policy response needs to be coordinated to make such a levy effective.

By their very nature various forms of financial assets are highly mobile internationally and susceptible to opportunistic transfer in response to changes in levels of taxation where these might apply. Generally, taxes on financial assets or financial transactions are best coordinated at international level to minimise the risk of revenue loss through

[11] ***http://stats.oecd.org*** refer to Revenue Statistics - Comparative Series dataset.

outflows of financial assets. However, a wealth tax levied on global assets of Irish citizens such as is the case in France should be considered.

Immobile assets such as land and buildings as well as high-value possessions provide a more easy to reach form of wealth. Ireland is one of a number of European countries that do not have at least some form of taxation on the stock of wealth. Taxes are levied, however, on capital gains or transfers of capital assets – subject to reliefs and various conditions.

Taxes on wealth can take two forms: taxes on households and taxes on corporations. At this time the Central Bank (Central Bank, 2012) estimates that the non-financial corporate sector liabilities exceed assets implying negative net financial wealth for non-financial corporates. We propose a tax to the net wealth of households after exclusion of liabilities including mortgages or other loans[12].

The case for a timely and well-designed wealth tax in Ireland is justified on grounds of:

Equity – those best able to afford to pay more tax should do so;

Efficiency – additional taxes on income (especially at modest levels) and consumption may have damaging effects on economic activity whereas taxes targeted at assets especially those that are less productive or idle can boost government revenue and provide greater economic incentive for the use of productive assets;

To design a well targeted, equitable and growth-friendly wealth tax some exemptions would be necessary. These could include for example:

- The principal place of residence up to a value of €1 million;
- Agricultural land in productive use and forestry;
- The first €100,000 of other eligible wealth;
- Wealth acquired as compensation for accidents or injury; and
- Works of art or buildings on public display.

It should be possible to exclude some categories of wealth such as that of the principal residence or land attached to that residence up to a certain size or value, as well as furniture and household effects. Based on information supplied by the Minister for

[12] The present value of pensions is an important form of wealth but very difficult to quantify given uncertainties in relation to future values of benefits as well as in life expectancy. It is therefore not proposed to include the value of such wealth in assessing high-income/high-wealth households for a wealth tax.

Finance in 2011 it is estimated that a tax at an annual rate of 1% on the net market value of the taxable wealth of ordinarily domiciled individuals, discretionary trusts and private non-trading companies, might yield in excess of €500 million.

The Central Statistics Office is currently planning a Household Finance and Consumption Survey the results of which, it is hoped, will be available in 2014. This is very welcome and will, hopefully, provide much needed information on the size and distribution of various types of wealth in Ireland. However, such statistical information is intended to inform debate – not provide a database against which assets would be assessed for tax liability.

Pending the development of a comprehensive database of wealth and assets it should be possible to introduce a system of self-assessment of assets coupled with a system of financial penalties for under-reporting of liable assets. A tax credit of €200 in the first year could be provided towards a professional assessment of personal wealth.

We estimate that such as tax might raise €200 million initially (in 2013) and a somewhat greater amount in later years.

5.3.2 Capital Taxes

Capital Gain Tax (CGT)

Recent increases in CGT (from 20% to 25% and to 30% in Budget 2011) are welcome as the beneficiaries of these gains are better placed to meet tax liabilities than those on low earnings. However, the current CGT rate still contrasts with the rate of 40%, which was temporally reduced to 20% in Budget 1998. At the very least it is time that the rate returned to its pre-budget 1998 level. Over time, there seems merit in treating capital gains as the same as any other source of income and subjecting these gains to income tax, USC and PRSI as with any other form of income. The Budget should also lower the annual threshold for CGT liability from €1,270 to €1,000.

Capital Acquisition Tax

The rate of Capital Acquisitions Tax (Gift Tax, Inheritance Tax and Discretionary Trust Tax) should be reformed in line with the rate for CGT, i.e. increased from 30% to 40%. In recent years the CAT thresholds for parent to child inheritance has been reduced from a peak of €542,544 in 2009 to €250,000 in 2012. While this is welcome, there remains room for this tax to be structured in a more progressive way with lower thresholds and rates of CGT which increase incrementally in line with the size of the gain.

The existing exemption thresholds should be further reduced, especially in relation to the generous thresholds allowed in respect of agricultural and business reliefs (where, for example, a reduction from the current 90% exemption rate to 60% could yield an a significant amount of additional revenue). It is also possible that business and agricultural relief should be restricted. Discretionary Trusts have been used for the purposes of tax avoidance. Much tighter legislation in the area is required with a curbing of tax avoidance vehicles.

Class S rate of Social Insurance and the Universal Social Charge should be extended to all gifts and inheritances (Capital Acquisitions Tax) where the charge would be levied on the gross amount and not just the taxable amount.

5.3.3 Site Value Tax to Pay for Local public Services

The Government is committed under the terms of the *Memorandum of Understanding* with the Troika to introduce a value-based property tax as part of Budget 2013. While the Government is free to negotiate the detail of the Memorandum, and as they have proven previously alter the composition of taxation increases and expenditure reductions, we consider it worthwhile that the Budget will broaden the tax base to include property. Such a tax should be tied to the provision of local public services and tied to the funding of local authorities. Overtime, reflecting the recommendations of the Commission on Taxation (2009) the tax should be moved to being set locally so that people associate the level of a property tax directly with the local services and facilities provided by their local authority. Such a development could also assist in strengthening local democracy.

Of the options available to Government, the introduction of a Site Value Tax (SVT), rather than a tax based on a property's value, would be the best option to pursue. A SVT would be based on the value of a property's site rather than how it is being used. As such, it would reward the efficient use of land in urban areas; smaller houses and apartment would pay less than larger ones in the same area. Similarly, a SVT would be linked to the scale and quality of public services in an area; in areas where there are many available public services, such as in cities and large towns, land values are higher reflecting the provision of these services and the decisions made by public authorities in terms of developing these areas and providing and subsidising these services. A SVT would reflect this value and collect an annual payment towards its provision irrespective of whether the land is being used for housing or held underdeveloped for speculative purposes.

In an NERI working paper last year, Collins and Larragy (2011) outlined a possible structure for the establishment of a SVT. They suggested the tax be based on the Property Registration Authority of Irelands (PRAI) land registration database which covers most of the sites in the country. The SVT would be charged on a square-meter basis and administered by the Revenue Commissioners and the PRAI. The proposal suggested a higher charge per square meter for sites in urban local authority areas, highest for large cities and lower in smaller cities and towns, and a lower charge for rural residential sites given their smaller provision of local services.[13] On average it would collect €200 per household raising annual revenue to fund local authorities of approximately €300m.

As a SVT will take a number of months to set-up, explain and publicise, the forthcoming Budget should introduce this tax on a half year basis in 2013 and then on a full year basis from 2014. The revenue target for 2013 should be €300m and twice this for 2014. In time, increases in this tax can be used to offset recent increases in consumption and income taxes, in particular the former given its regressive nature, necessitated by the collapse of taxation income in recent years.

Any proposal for a SVT needs to take account of two key issues:

- *Ability to pay*: and in particular it needs to be structured in a way that it incorporates exemption for low income households and local authority tenants and facilitates those on temporary low incomes (the unemployed etc) to defer or offset the tax. In the first few years of the tax, there may be merit in phasing it in for middle and lower income households.
- *Simplicity to pay*: the SVT should be structured so that it is as easy as possible for households to pay it. The Commission on Taxation (2009) offered a number of suggestion on how to overcome this including allowing people to include it in their PAYE, making incremental payments across the year etc.

Overall, for a property tax to work, it needs to be clearly explained, recognise ability to pay and be as simple as possible to pay.

[13] This paper is available on the NERI website: **http://www.nerinstitute.net/research/designing-a-site-valuation-tax**

While it is the case that if Government's objective is purely to raise additional revenue, the income tax system offers a much easier way of raising this revenue. However, the benefits of a property tax, and in particular a SVT, is that it broadens the tax base to introduce a recurring stable source of revenue for local government, it begins to address taxing people's wealth and it will act as a dampener for speculative land and property development in the years to come.

5.4 Corporation Profits Tax

Moving towards European norms will be an important step in the long-term for Ireland. Modest changes are proposed in Budget 2013 with the possibility of a clear signal that no major changes will be made for a longer period pending agreement at European level.

Approximately €4 billion is collected annually in corporation taxes. This is the equivalent of 2.5% of GDP. Notwithstanding the low nominal rate of tax (12.5%) on the vast majority of corporations, the huge scale of profitable multinational enterprise activity generates significant flows of revenue to the exchequer. As a long-term competitive strength low corporation taxes do not constitute a solid basis for enterprise policy. A start needs to be made to increase the contribution of corporations in regard to the large number of tax reliefs as well as options for carrying forward trading losses. There should be a review of the corporate tax base, that is, the basis on which tax is levied. There are many deductions against the nominal rate of 12.5 per cent, which have the effect of reducing it to nil in some instances. 60 per cent of Irish companies do not pay any corporation tax because they do not make sufficient profits. Most of these deductions against Corporation Tax are eminently justifiable incentives such as wear and tear on plant and machinery but some should be eliminated and others reduced.

Stewart (2011) explored the area of effective tax payments and warns that it is complex and dependent on definition and interpretation. Using US data on firms in Ireland, he found that US firms typically paid an effective rate of tax of between 4.2 and 5.3 per cent, but he also found that some pay even less, as do many Irish firms.

While the rate of corporation tax may not be under consideration by the Government for reform, it should focus its efforts on reforming how companies use the taxation system to minimise their profits, taxes and contributions to the public purse.

5.4.1 Carrying Forward of Losses

The Government should reform the methods by which losses can be carried forward. Under the current system, companies have the facility to take a corporate loss back to the previous year of trading; to move losses in a company between trades; and there is a facility for terminal losses which allows a loss to move back for three years when a company ceases. These generate repayments of tax in many cases. Such practices are of dubious economic impact, are regressive and are in many cases transferring various risks from corporate activity indirectly onto the exchequer.

5.4.2 Undistributed Reserves

These arise where companies make a profit but do not draw it down as income for owners/shareholders for a long period. Consequently, these can sit on the balance sheet, having contributed only 12.5% to the state in corporation taxes, until the directors reach age 55. The directors then retire with a lump sum taken out of the reserves (which for example is individualised for husband and wife at €500,000 each), tax free under capital gains tax rules and does not attract income tax or Universal Social Charge (USC). This provision should be eliminated entirely and/or Capital Acquisitions Tax should be used as a penalty.

5.4.3 Deductions of Interest

The area of deductions of interest should also be reformed. We suggest a limit on interest paid by companies as a percentage of a company's assets. This would prevent speculative debt financed takeovers of firms with the sole aim of short-term dividends and profits. The practice of allowing interest charged but not paid as a deduction against tax should be terminated forthwith. This practice is common where interest is allowed for tax purposes, despite the fact it has not been paid. Such measures generate a larger loss, which can be offset against a profitable year thus reducing further the effective tax rate of companies.

In general, these reforms are of greater relevance to indigenous rather than foreign owned companies as the latter tend to avail of the low corporate tax rate in Ireland and repatriate their reserves to home.

5.4. Other Taxation reforms

5.4.1 Employer and Employee Social Contributions

Given the uncertainty with regard to the employment impact of changes to employer PRSI it is not proposed to alter this rate at this time save for a reform of employer PRSI paid in regard to employees working on a part-time basis. We propose an extension of PRSI on certain unearned incomes including capital gains and capital acquisition tax.

5.4.2 Indirect taxes

Increases in indirect taxes hit lowest income households hardest - those who spend all their income and have little if anything left over to save. Budget 2012's increase in the standard rate of VAT hit these households hard and the proposed increase in the carbon tax in Budget 2012 will also impact hard on low income and working households already struggling to pay their fuel and heating bills and pay for their transport (the costs of public and private transport will be driven up by the higher carbon tax). Government needs to take care in making these reforms and in the medium-term should prioritise reductions in VAT as tax revenues recover.

Motor tax currently provides a portion of the funding for local government. In recent years, motor tax receipts have fallen, driven by declining car sales, a decrease in the number of cars on the road and drivers switching to lower Co2 emitting cars. Since 2008 motor tax receipts have fallen from €1,060m to just under €1,000m in 2011 (Department of Finance, Budget 2012). Government plans to restructure motor tax as part of Budget 2013 and it should do so in a way which stabilises this revenue source for future years. The reform should continue to adopt the approach of taxing heavier polluting vehicles.

6 Conclusion

To date the Fiscal Advisory Council has issued a number of reports making the case for increased or front loaded consolidation measures. In its most recent report it makes the case for an additional €1.9 billion adjustment on top of what has already been signalled for the years 2013-2015 although it did not advocate additional measures in the forthcoming budget.

At this fragile state of economic development it is imperative, in our view, to avoid causing further damage to domestic demand and employment. In recent months voices have been raised to the effect that 'middle Ireland', let alone those in poverty or without work, cannot take any more. In this Observer we have outlined the case for an alternative adjustment in this coming budget. Such an adjustment could lead to the same deficit outcome (7.5% of GDP) but would protect existing levels of front-line services and social protection while factoring in reductions in the total public sector pay-bill. It would also avoid the likely loss in jobs estimated by us as 29,000 resulting from a spending-intensive large fiscal adjustment of €3.5 billion in this December's budget.

The wheels of the fiscal car continue to spin in the mud as additional pressure on the accelerator of fiscal austerity leaves little impression on employment, output or consumer confidence. Instead we need a rubber mat of an investment stimulus under the fiscal wheels to allow a lift off from the recessionary mud. An export-led recovery towing van would certainly help if such were available but such outside help alone is not enough.

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7 Appendix (Supplementary Data)

Table 7.1. Overview of key economic trends since the onset of the current economic crisis – Republic of Ireland

	2007	2008	2009	2010	2011
Total Expenditure					
Consumption €m	92,724	94,153	83,155	82,060	81,308
Investment: private and public €m	48,377	39,324	25,601	18,745	16,112
Government current spending €m	28,997	30,482	29,213	26,170	25,410
Exports €m	152,389	150,181	146,369	157,810	166,791
Imports €m	135,328	133,877	120,352	128,326	131,875
Domestic Demand €m	171,122	163,628	136,479	126,422	123,056
Total Income					
GDP €m	188,729	178,882	161,275	156,487	158,993
GNP €m	162,209	153,565	132,911	130,202	127,016
Income from Agriculture €m	3,130	2,705	2,064	2,555	3,248
Income non-Agriculture: Wages €m	78,222	80,960	73,452	68,696	67,765
Income non-Agriculture: Other €m	66,395	56,000	50,768	54,443	58,056
Employment					
Labour Force	2,253,100	2,266,600	2,202,300	2,150,500	2,120,300
Labour Force Participation Rate %	64.6	64.2	62.5	61.2	60.4
Employment	2,149,800	2,107,100	1,922,400	1,851,500	1,805,500
Employment full-time	1,764,000	1,712,700	1,510,300	1,436,800	1,383,700
Employment part-time	385,800	394,400	412,100	414,700	421,800
Underemployment	n/a	92,900	108,900	108,800	135,700
Unemployment	103,300	159,400	279,800	299,000	314,700
Unemployment %	4.6	7.0	12.7	13.9	14.8
Long-term Unemployment	28,800	38,100	71,400	140,400	177,200
Long-term Unemployment %	1.3	1.7	3.2	6.5	8.4
Migration					
Immigration	109,500	83,800	57,300	30,800	42,300
Emigration	42,200	45,300	65,100	65,300	76,400
Net Migration	67,300	38,500	-7,800	-34,500	-34,100

	2007	2008	2009	2010	2011
Public Finances					
Total General Gov. spending €m	69,539	77,009	78,111	103,271	75,283
Total General Gov. revenue €m	69,705	63,884	55,648	54,836	55,261
General Gov. Balance €bn	0.1	-13.2	-22.5	-48.6	-20.5
General Gov. Debt nominal €bn	47.4	79.6	104.6	144.2	169.3
General Gov. Debt % GDP	24.9	44.2	65.1	92.5	108.2
Earnings and Prices					
Average earnings € per week	n/a	696.72	699.10	693.70	687.67
Average earnings % change	n/a	n/a	0.3	-0.8	-0.9
Private sector av. earn. % change	n/a	n/a	3.6	-2.4	-2.5
Public sector av. earn. % change	n/a	n/a	-2.4	-0.8	0.7
Inflation CPI %	4.9	4.1	-4.5	-1.0	2.6
Inflation HCPI %	2.8	3.1	-1.7	-1.6	1.1
Inequality and Poverty					
Gini coefficient	31.7	30.7	29.3	33.9	n/a
Quintile ratio	4.9	4.6	4.3	5.5	n/a
Relative poverty %	16.5	14.4	14.1	15.8	n/a
Consistent poverty %	5.1	4.2	5.5	6.2	n/a
Deprivation rate %	11.8	13.8	17.1	22.5	n/a

Sources: CSO Quarterly National Accounts; CSO National Income and Expenditure; CSO Quarterly National Household Survey; CSO Population and Migration Estimates; CSO Earnings and Labour Costs; CSO Consumer Price Index; CSO SILC Report 2010; Department of Finance Budget 2012; IMF Ireland Country Report June 2012; Eurostat online database.

Notes: Earnings and labour market data are for Q3 in all years. Figures for 2011 are preliminary estimates.
National accounts data reported at current market prices.
Underemployment calculation - new series from 2008.

Table 7.2 Overview of key economic trends since the onset of the current economic crisis – Northern Ireland

	2007	2008	2009	2010	2011
Total Expenditure					
Personal consumption £m	-	-	-	-	-
Investment: private and public £m	-	-	-	-	-
Government consumption £m	-	-	-	-	-
Exports £m	5,476	6,199	5,143	5,299	5,733
Imports £m	4,810	5,570	5,028	5,210	5,532
Domestic Demand £m	-	-	-	-	-
Total Income					
GVA £m	28,192	28,827	28,256	28,162	-
GNP £m	-	-	-	-	-
Income from Agriculture £m	454	383	319	-	-
Income non-Agriculture: Wages £m	-	-	-	-	-
Income non-Agriculture: Other £m	-	-	-	-	-
Employment					
Labour Force	816,000	823,000	804,000	829,000	846,000
Labour Force Participation Rate	60.5	60.3	58.4	59.6	60.3
Employment	783,000	786,000	754,000	772,000	785,000
Employment full-time	611,000	608,000	585,000	589,000	608,000
Employment part-time	171,000	174,000	167,000	180,000	172,000
Underemployment	16,000	17,000	27,000	27,000	32,000
Unemployment	33,000	37,000	50,000	58,000	62,000
Unemployment rate %	4.1%	4.5%	6.2%	6.9%	7.2%
Long-term Unemployment	12,000	13,000	15,000	22,000	29,000
Long-term as % of Unemployed	36.4	33.9	29.8	37.8	47.7
Migration					
Immigration	19,369	15,350	12,690	11,854	-
Emigration	11,332	11,039	11,229	11,262	-
Net Migration	8,037	4,311	1,461	592	-

	2007	2008	2009	2010	2011
Public Finances					
Total General Gov. spending £m	18,425	19,054	19,871	19,654	-
Total General Gov. revenue £m	-	-	-	-	-
General Gov. Balance £m	-	-	-	-	-
General Gov. Debt nominal £m	-	-	-	-	-
General Gov. Debt % GDP	-	-	-	-	-
Nominal earnings and Prices					
Average earnings £ per week	329.9	345.0	354.6	354.7	360.0
Average earnings % change	2.2	4.6	2.8	0.0	1.5
Average earnings % change – private sector	-	-	-	-	3.5
Average earnings % change - public sector	-	-	-	-	3.9
Inflation CPI %	-	-	-	-	-
Inflation HCPI %	-	-	-	-	-
Inequality and Poverty					
Gini coefficient	-	-	-	-	-
Quintile ratio	-	-	-	-	-
Relative poverty %	-	-	-	-	-
Consistent poverty %	-	-	-	-	-
Deprivation rate %	-	-	-	-	-

Sources: HMT Public Expenditure Analysis 2011; DETI Labour Market Bulletin; HMT RTS; ONS Regional Trends; NISRA National Statistics; LFS Historical Data Series 1995-2011; LFS Quarterly Supplement; NISRA Northern Ireland Migration Flows; NISRA Annual Survey of Hours and Earnings.

Note: Where cells are blank the data are unavailable.

Notes

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