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BASE-BROADENING TAX REFORMS

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At given levels of economic activity, increases in tax revenue require either higher tax rates or a wider tax base. Higher tax rates cause greater distortions to economic decisions, so widening of the tax base is preferred on efficiency grounds. But considerations of fairness and ability to pay are also relevant, as pointed out by Geary Lecturer, James Poterba: "There is often a trade-off between an efficient tax system which has a very broad base and low rates and a tax system which ....does not put substantial burdens on those with relatively low ability to pay". (Poterba, 2010, p. 135) The balance between these considerations cannot be decided on a purely theoretical basis: careful analysis of particular proposals for widening of the tax base or changes in tax structure are needed. Recent research under the Institute's programme for Taxation, Welfare and Pensions has helped to clarify the impact of alternative base-widening options in three areas: property tax, the tax treatment of pension contributions, and the tax treatment of child benefit. Brief summaries of the findings of each of these pieces of research are given here, and links to the full publications are to be found at the end of this article.

Property Tax

Annual taxes on property make a significant contribution to tax revenues in many OECD countries. In the Irish context, taxes on property have been focused on stamp duties, payable when a property is changing hands. There are two major drawbacks to this transactions-based approach. First, stamp duties put barriers in the way of mobility and distort decisions about whether to move or to refurbish/extend an existing home in the face of changed circumstances. Second, a transactions-based tax is vulnerable to cyclical variation, as evidenced by the collapse of stamp duties from the housing market in the recent past. An annual property tax, of the type proposed by the Commission on Taxation, could provide a more stable source of revenue while encouraging efficient use of the housing stock.

How could a property tax be designed to take account of ability to pay? Callan *et al.* (2010) show that a property tax could be designed to take account of the income of property-owners, and still raise substantial revenue. For example, a tax which provided full or partial relief to the poorest one-third of the population could still raise revenue of close to €1 billion per year.

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An annual property tax would widen the tax base from one consisting of sales and purchases of property, to one including all residential property. Instead of a high rate on infrequent transactions, there would be a low rate for an annual tax. There are strong efficiency arguments in favour of this approach. But there are also issues of fairness involved in the transition from a long-standing regime based on stamp duties to one based on an annual property tax. The Commission on Taxation recommended an exemption from the annual property tax for a fixed, seven-year period from the date of purchase. An alternative would be to vary the length of the exemption to take account of the rate of stamp duty paid, and the point in the house price cycle at which it was paid. Consequently those who paid most stamp duty during the years of rapidly rising house prices would obtain greatest relief.

Tax Treatment of Pension Contributions

Currently, pension contributions are excluded from taxable income. The National Pensions Framework contains a commitment to change the tax treatment of pension contributions. Instead of providing relief on pension contributions at the taxpayer's marginal rate (either the standard rate of 20 per cent or the top rate of 41 per cent) the Framework envisages a matching contribution equivalent to tax relief at a hybrid rate of 33 per cent (with the delivery mechanism yet to be determined). Recent ESRI research (Callan *et al.*, 2009b) helps to identify the potential impact of this approach.

The rationale for a standardized rate of relief or support for pension contributions is that under current arrangements there are strong incentives for high income earners to participate in pension schemes, but a weaker incentive for those with low and middle incomes. The proposed changes would tilt this balance, with a reduction in the incentive for those on high incomes and an increased incentive for those on low and middle incomes. Analysis of a shift towards relief at a single 30 per cent rate – similar to that proposed in the National Pensions Framework – shows that the immediate impact would involve gains for standard rate taxpayers and losses for top rate taxpayers, and a net gain to the Exchequer in the region of €500m per year.

Evidence from the UK and the US suggests that much of the saving by high income households would take place even without the incentive (what economists call "deadweight loss") – although it might take place in different forms. There is also growing evidence that decisions on pensions can be strongly influenced by non-economic factors, at lower cash cost to the Exchequer. For example, pension schemes in which the default option is to enrol in the scheme ("auto-enrolment"), but with an option for individuals to withdraw (sometimes called "soft mandatory"), have been found to be effective in other countries. The National Pensions Framework also contains a commitment to the introduction of an "auto-enrolment" scheme.

Child Benefit

Currently child benefit is not included in the definition of income for taxation purposes. Widening the income tax base to include child benefit could allow the net benefit to be better targeted, ensuring that the greatest net benefit is obtained by those with the lowest incomes. A key advantage of the taxation approach is that it would not involve new benefit withdrawal rates but would instead use the existing tax rates to improve targeting. Means-testing, on the other hand, would involve new benefit withdrawal rates which would operate in addition to the income tax rates. These issues were explored by Callan *et al.* (2009a) in the context of the choices facing government in framing cuts in expenditure in Budget 2010, and remain relevant today.

The Commission on Taxation advised that Child Benefit should be included in taxable income, but that this suggestion should be compared to the alternatives, such as means testing. The Report of the Special Group on Public Service Numbers and Expenditure Programmes also suggested either making Child Benefit taxable, making it a means-tested benefit or reducing rates to arrive at a 20 per cent cut in expenditure. Budget 2010 opted to reduce Child Benefit payment rates by 10 per cent, with a compensating increase in the child dependant additions for recipients of social welfare payments.

A means test on Child Benefit would involve a new "benefit withdrawal rate" which acts to increase effective marginal tax rates (i.e., the proportion of an increase in gross income which is deducted either in the form of increased tax and social insurance or withdrawal of welfare benefits). Thus it would tend to boost out-of-work income relative to in-work income, and would certainly lead to higher marginal tax rates facing some of those in work. Making the payment taxable would also have some impact on marginal tax rates, as some of those with children would move to a higher tax rate, or into the tax net – but the net impact on incentives would be lower. The "rate cutting" option would reduce income in work and in unemployment by the same amount, leaving the gap between the two unchanged. Cutting rates of Child Benefit while providing compensation through child dependant addition payments – the option chosen in Budget 2010 - tends to narrow the gap between in-work and out-of-work incomes. Looking to the future, the option of broadening the base to include Child Benefit as part of taxable income offers a structure which could help to balance the objectives of providing greater support at lowest income levels, moderate effective tax rates, a payment which reaches all children, and a sustainable overall Exchequer cost.

Conclusion

Efficiency considerations point towards the advantages of low tax rates on a wide base. Tax policy must also take into account other considerations, including concerns for fairness and ability to pay. Where these goals come into conflict, careful analysis of the options is needed to inform judgements as to the best balance. The research summarised here illustrates how the issues vary depending on the nature of the base-broadening proposal – there is no short-cut method which can provide easy answers or avoid difficult judgements.

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