Income Taxation in Ireland

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Taxation is the process by which the people pay the expenses of carrying on government. Its genesis can be traced to the earliest and simplest societies. This paper analyzes the income taxation system that is in place in Ireland. The principles of taxation are delineated, and the extent to which the Irish system conforms to these is examined.

The discussion is divided into four sections. The first of these looks at the functions of taxation. Section two deals with the Irish tax base, an aspect of the system that is of fundamental significance. Section three examines the implications of the rating structure that is employed in the collection of Irish levies. Finally, section four looks briefly at the impact that the system has on equity and distribution.

The functions of taxation

The purpose of taxation is not merely to finance government expenditure. The taxation system can be designed in such a way as to fulfill other objectives such as redistribution of resources, regulation, social partnership and co-operation with other governments. These are goals which, as societies become more advanced and sophisticated, the government is put under increasing pressure to attain.. In this context, a properly designed taxation system can constitute an extremely effective policy tool.

However, it must be remembered that there are certain principles to which taxation systems must conform. The selection of these principles represents a value judgement, but it is arguable that more people would subscribe to a system that is stable, simple, fair and just than to one which did not embody these qualities. Society does not admit of the unconstrained imposition of taxes to achieve government objectives.

Having delimited the purposes of taxation, the question of the extent to which the Irish tax system fulfills these functions while conforming to the requisite principles arises. It is this issue that the following sections deal with.

The Irish tax base

If a common theme running through the five reports published by the Commission on Taxation between 1982 and 1986 is to be chosen, it is arguably that of the relatively diminutive Irish income tax base. The reason for this small tax base is the complex set of deductions that are allowed to tax-payers prior to assessment. The immediate consequence is that average tax rates have to be high in order that sufficient revenues accrue to the exchequer.

The deductions permitted are of four kinds: allowances, exemptions, reliefs and exclusions. The discussion here focuses on the third and fourth of these.

Reliefs

Reliefs relate to certain specified expenses. There are of two types: business and non-business. The former are availed of primarily by the self-employed, and it is from them that much of the dispute between the PAYE and self-employed sectors stems. It is argued that specious claims allow the amount of assessable income to be artificially reduced by those who are self-employed. However, it must also be remembered that taxation on benefits-in-kind mitigates this horizontal inequity to some extent.

Non-business reliefs can be claimed by everybody. Categories include life assurance, medical insurance and mortgage interest relief. It is contended by some that the higher income groups are the ones best positioned to take advantage of such reliefs, and that therefore they exacerbate vertical inequities. In effect, they constitute a tax avoidance mechanism.

In the 1991 Budget, the Fianna Fail/ Progressive Democrat coalition took some steps towards correcting these deficiencies (see article by Tony Lynch in this volume). Life assurance premium relief (LAPR) was cut form 50% to 25% of allowable premiums. Some commentators suggest that the complete elimination of this relief would remove what has been a significant distortion in the Irish savings market for some time now (*Irish Times*, issue dated February 1,1991). However, the removal of this and other reliefs may prove difficult, since in many cases the benefit has become capitalized. An example of this is mortgage interest relief, the introduction of which spawned a rise in house prices, and hence benefited house owners rather than house buyers as it was intended to do.

Exclusions

Certain types of income are not treated as income by the tax authorities and therefore excluded from tax. These include capital gains, gambling winnings and owner occupancy. Subsequent to the criticism which these exclusions received in the reports of the Commission on Taxation, some steps, albeit minor ones, were taken to redress their effects.

Capital gains are subject to a separate category of assessment, but the efficacy of this separate category is severely compromised by the large exemptions which apply within its own schedule. The rates applied are also lower than those levied on income, resulting in a distortion in favour of capital as opposed to interest earnings. The overall consequence is a loss of revenue to the exchequer.

Owner occupancy is treated very favourably within the Irish tax system, and those who rent are consequently discriminated against. Many argue that owner occupancy should be taxed as a form of imputed income to ensure greater equity. Once again, however, the problem of capitalization impinges, and it would be difficult in practice to introduce such a reform.

Together with allowances and exemptions, these categories of reliefs impact severely on the Irish tax base. According to one estimate they reduce it by as much as 43%. In this light, the Commission on Taxation's calls for a significant widening in the tax base must be seen as legitimate. However, to the economy's detriment, the reforms suggested by the Commission have not been instituted.

The schedule of rates

It was noted above that an immediate consequence of a contracted tax base is the imposition of high *average* tax rates. Yet the Irish system is also characterized by high *marginal* tax rates. These give rise to a number of effects which are discussed below.

Progressivity

In Ireland, taxable income is subject to tax according to a progressive schedule. The applicable rates are, for fiscal 1991, 29%, 48% and 52%. However, marginal rates do not increase uniformly with income for a number of reasons. Above a certain income level, PRSI contributions are not applicable (the 1991 Budget removed the ceiling on health contributions). Below a certain income level, the youth employment levy and health contributions are not applicable. In addition, the existence of the general exemption limit implies a very high marginal tax rate over narrow ranges of income. The average income earner is currently assessed on a large portion of his or her income at the top rate of 52%. This issue of progressivity will be returned to below briefly in the context of the redistributive role of the Irish tax system.

Work behaviour

It is arguable that high marginal tax rates have a disincentive effect on work effort. The effect of this on employment and emigration is difficult to measure, but probably significant. High *average* tax rates contribute to the poverty trap (*Irish Times*, issue dated March 7,1991). It is likely though, that the root cause of the poverty trap is the welfare system rather than the taxation system.

Avoidance and evasion

Perhaps the most significant impact of high marginal and average tax rates is revealed in the extent of tax evasion and avoidance that occurs in Ireland. This is borne adequate witness to by the "success" of the tax amnesty in 1988.

Avoidance is an individual's manipulation of his affairs within the law so as to reduce his tax liability. Evasion, by contrast, is illegal.

One manifestation of avoidance was the Business Expansion Scheme (BES). It was designed to stimulate investment in high-risk business and service ventures by offering tax incentives. In practice, it was used to reduce tax bills on projects which carried little risk. This was the main reason for its effective abandonment in the 1991 Budget.

These problems are compounded in Ireland by legislative deficiencies. The penalties resulting from avoidance and evasion are relatively low in Ireland. While the revenue authorities have increased their efforts to combat evasion, they are hindered by the secrecy accorded to bank and building society account holders. In addition, the authorities are lax in their pursuit of offenders. Evaders are forewarned prior to inspections. In contrast to the US, which has 2500 in jail for tax offenses, and Denmark, which has 50, Ireland at present has no one sentenced (*Sunday Business Post*, issue dated February 3,1991). Finally, the social conscience is weak. Those who can "fiddle the system" are accorded a certain amount of respect.

Avoidance and evasion are prominent in the Irish context. The consequence is that the effectiveness of the tax system in performing its functions is compromised; rates have to be increased to raise a given amount of revenue. Prospects for the redress of this problem hinge on the adoption of lower rates, and the imposition of more severe penalties for evasion.

This section has discussed a number of aspects relating to the Irish system of tax rates. The fourth section now looks briefly at the redistributive role which this system plays.

Taxation and redistribution

The important distinction to make in this context is between horizontal and vertical equity. The former means that people in similar circumstances should be treated equally. The latter embodies the idea that people on higher incomes should pay proportionately more tax.

As was mentioned above, controversy surrounds the extent to which horizontal equity is debilitated by the existence of business reliefs for the self-employed sector. In recent years, the average tax burden of the PAYE workers has declined to a level below that of the self-employed. The potential for inequity remains, however, and, as concluded above, a solution to the problem must lie in reform of the the system of reliefs and a widening of the tax base.

In theory, the progressive nature of the Irish income tax system should enhance vertical equity. However, the nominal progressiveness of a tax system is a necessary but insufficient condition for actual progressiveness. In Ireland, the complex system of allowances, reliefs and levies has created a situation where the income tax system is regressive in the aggregate. As a result, income distribution in other EC countries tends to be more equitable than that in Ireland.

Conclusion

This paper has analyzed the Irish income tax system. The functions and underlying principles of any such tax system were first discussed. Then the contentious issue of the Irish tax base was examined. Section three looked at the Irish schedule of tax rates. Finally, section four dealt, albeit briefly, with the principle equity issues arising.

Urgent reform is needed, but how this reform should proceed is unclear. There are huge administrative costs involved in the overhauling of any tax system, and there is no guarantee that the new system would be any better than the old. Although criticized for doing so, given the uncertain international climate, it is not surprising that Mr. Reynolds, the Minister for Finance, chose minor changes rather than tax reform in the 1991 Budget. Yet the issues are not ones which will dissipate with time. While it is politically, feasible, the drive for tax reform should be pursued with renewed vigour.