An investigation of the effects of taxation on Irish unemployment

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A frequently cited explanation for Ireland's persistently high unemployment is the tax burden borne by the labour market. Diarmaid Smith examines the disincentive effects of taxation and the incidence of Irish taxation. He concludes with a discussion of possible reforms.

With 182,000 people currently out of work in Ireland (according to the labour force survey), and over twenty million in Europe, unemployment remains the central concern in economics. The purpose of this paper is to outline how taxation has contributed to the rise in Irish unemployment since the 1970s. In order to proceed along these lines, I will begin by briefly examining why unemployment is of such importance, before going on to critically assess the significant impact of taxation on the growth of unemployment over recent decades.

High, and in particular, long term unemployment is extremely costly in the sense that it signifies a waste of resources, forgone output, income, tax revenues and consequently often severe budgetary implications. In fact, the outstanding feature of Irish unemployment has been its extraordinary persistence, with over 60% of unemployed people out of work for more than one year. This is particularly damaging in the sense that the long-term unemployed suffer from both de-skilling and de-motivation as well as being stigmatised in the eyes of potential employers as being unproductive. As a direct consequence of this, the probability of leaving unemployment declines considerably with time spent unemployed. There is a great danger, therefore, that a "dependency culture" can emerge and, because unemployment is typically widespread in disadvantaged areas, it can frequently result in a self-perpetuating cycle of deprivation and poverty, with inevitable far-reaching social ramifications such as crime, drug abuse, etc.

The average rate of unemployment in Ireland from 1960 to 1975 was a modest but stable 5.2%, but by 1979, unemployment had spiralled upwards towards 7.2%. The 1980s was a particularly bleak decade for the economy as unemployment soared to 17.3% by 1985 (see Table 1).

Table 1: Numbers employed, Numbers unemployed, the size of the Labour force and the percentage unemployed.

Year	Employed (1,000's)	Unemployed (1,000's)	Labour Force (1,000's)	% Unemployed
1975	1073	85	1158	7.3
1980	1156	91	1247	7.3
1985	1079	226	1305	17.3
1990	1126	179	1305	13.7
1991	1125	208	1334	15.6
1992	1125	225	1350	16.7

Source : McGettigan & Browne (1993).

This increase in unemployment, and the consequent decline in living standards (real GNP in 1987 was lower than in 1980) was caused by a combination of adverse world economic shocks and internal factors, coupled with growing legal and institutional rigidities in the labour market (which resulted in permanent rather than temporary unemployment). The external, and hence exogenously imposed, factors which contributed to a decade of economic stagnation were:

- The jump in real commodity prices caused by the OPEC oil price shocks.
- The deterioration in the UK economy whereby disinflationary macroeconomic policies resulted in British unemployment soaring from 4.5% in 1979 to an epic 11.8% in 1986.
- Real interest rates became strongly positive in the 1980s, whereas they had been overtly negative in the 1970s.

The above factors helped to depress demand and output, and curb emigration (initially) in Ireland, thus causing job losses. Although we had no control over these factors, domestic macroeconomic policy unquestionably proved to be the major cause of Ireland's rising unemployment. This can be seen through the Government's attempt to pursue a strongly expansionary fiscal policy in the late 1970s, in a desperate attempt to mitigate against the adverse affects of the oil price shocks and a worsening world economic environment. Although such a policy was moderately successful in the short run in averting a wide-scale recession, it inevitably led to the build-up of a huge national debt as government deficits spiralled out of control in the 1980s. Consequently, fiscal policy was forced to become strongly contractionary from 1982 onwards, and thus both the unemployment rate and the tax burden soared. In fact, over the period 1979-1986, with the sole exception of Spain, Ireland had the worst performance in the OECD, in terms of both job creation, and unemployment prevention.

The 1980s were thus marked by pitifully low economic growth, rising unemployment and emigration, and a seemingly continual rise in the tax burden. As Tansey eloquently remarks: "The years of economic stagnation had been associated with increasing rates of government spending, accompanied by a sharp and continuous increase in the burden of taxes"[1]. As governments sought to finance the mounting deficits, the yield from income taxes and PRSI tripled in the 1980s, increasing their share of GNP from 16.3% in 1980 to 23% in 1987. Employees were particularly adversely affected as total employee income taxes soared from £1,163m in 1980 to £3,653m in 1990.

There were four main reasons why effective tax rates on labour became so high and penalising in Ireland, thus greatly contributing to unemployment by lessening work incentives. Firstly, the sub-indexation of basic tax allowances meant that an increasing proportion of workers' gross incomes were subject to taxation and, in addition, discretionary allowances and mortgage interest relief were cut back. Secondly, tax bands were squeezed, resulting in taxpayers paying increased rates of tax for relatively modest additions to their incomes (the phenomenon of "bracket creep"). In effect, the government used inflation as a hidden tax or, as Tansey points out, "inflation acted as a phantom tax collector for the exchequer"[2]. Thirdly, although improvements were made in reducing tax rates in the late 1980s, effective rates of tax remained excessively high and Ireland's starting income tax rate of 30% in 1990 was the second highest in the industrial world. Finally, further taxes on labour were introduced in the form of new levies, in addition to a rise in existing PRSI rates from 3.5% in 1980 to 6.75% by 1991.

The huge rise in the burden of taxation, which came in many forms, both direct and indirect, was a consequence of the expansionary policies pursued in the 1970s, and the negative impact on unemployment proved to be severe, "the unemployment of the 1980s has been to a significant extent a consequence of the fiscal mismanagement of the 1970s, when inappropriate policies were pursued, the tax base eroded and the national debt built up."[3] Undeniably, therefore, Ireland's exceptionally high levels of taxation contributed directly to the rise in unemployment, primarily, as we shall see, through the effects of the tax wedge on the workings of the labour market.

The tax wedge is the difference between what it costs an employer to hire a unit of labour (the product wage) and the real purchasing power that an individual derives from his post-tax income (the consumption wage). The wedge is of particular concern because it adversely affects the labour market on both the supply and

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[1] Tansey, P., 1991, p.7
[2] Ibid. p.31
[3] Barry, F. & Bradley, J., 1991, p.278

demand sides, as a wedge is driven between the cost of labour to the employer and the returns from work, leading to unemployment. Thus, it distorts the labour market, by disturbing the price mechanism; in fact, Tansey (1991) stresses that employers and employees no longer speak the same language when it comes to wage negotiations, since they respond to distinctly different sets of price signals, because of the myriad of taxes that they encounter.

It is estimated that the cost to the employer of granting a £1 increase in net income rose from £1.82 in 1980 to £2.58 in 1985. The tax wedge ensures that pay increases to workers are quite small in real terms, whereas the cost to the employer can be substantial. In fact, the OECD reported that, between 1979 and 1986, real labour costs rose by over 20% whereas real post-tax wages fell by more than 10%! The magnitude of the wedges' distortionary effects depends positively on the elasticity of labour supply and demand, both of which are relatively elastic in an Irish context, given the "openness" of the economy and the propensity of labour to emigrate.

In Ireland, the consensus among economists is that the incidence of any increase in income taxation is shared evenly between employers and employees, thus Barry (1991) reports that 50% of any increase in the wedge is passed onto employers in the form of increased wage demands, in the medium to long term.[4] In the early 1980s, for example, many indigenous and British industries based in Ireland were forced to close down, partly because of the deterioration in cost competitiveness as a result of the tax wedge and the increase in the real exchange rate by over 30% between 1974 and 1989.[5] Thus, these industries experienced heavy employment losses, as unit-labour costs spiralled ever upwards, a fact which is borne out by the evidence; "a major driving force behind the competitive loss has been the upward pressure on wage demands induced by the dramatic rise in the tax burden during the 1980s. The tax/GNP ratio grew faster in Ireland than in any other OECD country in this period."[6]

In 1987, Murphy estimated that a 1% increase in the tax wedge would reduce employment by between 0.2% and 0.25%. In addition, the NESC reported that the wedge rose by 27.3% between 1980 and 1985, thus causing at least a 7% fall in employment. This sharp and continuous rise in the wedge was a direct consequence of government economic policy, and a major cause of Ireland's traumatic employment experience in the 1980s. Indeed, the Barry & Bradley (1991) and Browne & McGettigan (1993) reports both reached the same conclusion - that domestic policy (and not external or demographic factors), was

[4] Barry, F., 1991, p.108
[5] Browne, F. & McGettigan, D., 1993, p.17
[6] Barry, F., 1991, p.108

primarily responsible for the rise in Irish unemployment, as Table 3 demonstrates. Barry summarises that, "domestic policy in the 1979-1986 period, operating primarily through tax increases, accounted for 4.4 percentage points of the 10.2 percentage point increase in unemployment."[7] According to Tansey, "large public sector deficits and heavy tax burdens were associated with job destruction rather than job creation."[8]

Table 3.: *Decomposition of Unemployment Changes : 1979-86.*

	Barry/Bradley	Browne/Mc Gettigan
External Factors	3.00	2.6
Domestic Policy Factors	4.41	4.5
Demographic Factors	0.60	1.8
All Factors Combined	8.44	8.9
Historical Data	10.2	10.2

Source : McGettigan & Browne (1993).

The tax wedge was also partly responsible for the huge increase in emigration during the 1980s, whereby over 200,000 people fled the country in search of employment and presumably lower tax regimes. In particular, young, highly-qualified, single people have continued to vote against the Irish tax system by emigrating. Such a trend adversely affects both the future skill base and dynamism of the economy. A further negative side-affect of our taxation policy has been the creation of a flourishing tax avoidance industry whereby entrepreneurial flair, guile and ingenuity have been devoted to searching for tax loopholes, rather than creating employment.

During the 1980s, an unemployment trap emerged on a large scale, as a direct result of both the tax and social welfare codes. Consequently, many of the long-term unemployed, in particular, have no financial incentive to search for employment, because effective tax rates and replacement ratios are so high. For example, the effective marginal tax rate for single people on average industrial incomes was over 55% in 1992. In the 1980s, expenditure on social welfare tripled, increasing its share of GNP from 10% to 13% and, as the Central Bank reported, *"relatively high replacement ratios and the indefinite duration of unemployment welfare payments is an institutional feature of the Irish labour market."*[9] In 1991 for example, the Minister for Finance reported that an entitlement to social welfare of £58 per week could be worth more than an earned income of £231! (Leddin & Walsh, 1995). Thus, for many, there is simply no

[7] Ibid.
[8] Tansey, P., 1991, p.88
[9] Browne, F. & McGettigan, D., 1993, p.27

incentive to seek work and, hence, there has been an increasing tendency for those in short-term unemployment to become long-term unemployed.

Another worrying feature of the Irish taxation system, has been its considerable bias in favour of capital over labour, whereby capital tax rates have been extremely low, and supplemented by various capital grants, subsidies and allowances, compared with the tax treatment of labour. The OECD concluded that, "no other OECD country has a tax system as biased against the use of labour as the Irish."[10]

Although, there have been recent improvements to encourage work via tax cuts, effective rates of tax remain considerably higher in the 1990s than in the 1970s, particularly for those on lower incomes; therefore, urgent and radical reform to both the tax and welfare systems is required.

Reforms

Integration of both the tax and social welfare systems would certainly help to alleviate both the unemployment and poverty traps, possibly through some form of negative income tax. At the very least, such an amalgamation would help the two codes to pull in the same direction, which was certainly not the case in the 1980s, when welfare payments were increased, seemingly without any reference to the tax system. Furthermore, the tax system continues to remain overly progressive at relatively low levels of income and overly biased against single people, for no economic reason. Marginal rates of tax must be reduced in order to both reward and promote work. Such reductions could be financed by cutting public expenditure and/or by abolishing many of the reliefs, exclusions and exemptions which exist at present (often to the benefit of the most affluent), all of which mean that marginal tax rates are higher than they need to be. Certainly, reductions in average rates of tax, especially for those on lower incomes, would help to extend the gap between unemployment payments and post-tax income.

The tax system should also be simplified by having one single system of tax rates, allowances and bands as opposed to the present plethora of levies, PRSI rates, etc. Increases in other forms of taxation (e.g. corporate and indirect taxation), would further help to spread the tax base as wide as possible, thereby facilitating tax rate cuts, which remains the pressing concern in Ireland, given the size of dead-weight losses associated with our taxation system, as Honohan and Irvine stressed, "the Irish taxation system is noteworthy for the narrowness of its base: much of income and expenditure is either effectively tax free or taxed at very low rates. This means that rates of tax on other goods or incomes have to be higher to obtain a

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[10] Tansey, P., 1991, p.37

given level of revenue. These are reasons for supposing the excess burden of taxation in Ireland to be very high."[11]

Conclusion

For almost two decades, unemployment has remained at a persistently high level, with the phenomenon of 'hysteresis' now firmly entrenched in European labour markets. For many young people growing up, high levels of unemployment have become very much the norm. However, while the unemployment problem in Ireland is chronic, it is curable. Although it might be naive of us to believe that governments can directly cut unemployment by significant amounts via monetary and fiscal policy, they can, by appropriate measures, help to create an economic environment which fosters employment growth. Unquestionably, a pro-jobs taxation policy must be an integral part of any reform, as high taxation on labour is not, and never will be, the requisite response to high and persistent unemployment.

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[11] Honohan, P. & Irvine, I., 1987, p.16