NESC REPORT NO. 37

INTEGRATED APPROACHES TO PERSONAL INCOME TAXES AND TRANSFERS

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NATIONAL ECONOMIC AND SOCIAL COUNCIL

Integrated Approaches to Personal Income Taxes and Transfers

No. 37

NATIONAL ECONOMIC AND SOCIAL COUNCIL

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1. The main task of the National Economic and Social Council shall be to provide a forum for discussion of the principles relating to the efficient development of the national economy and the achievement of social justice, and to advise the Government, through the Minister for Finance, on their application. The Council shall have regard, *inter alia*, to:

(i) the realisation of the highest possible levels of employment at adequate reward,
(ii) the attainment of the highest sustainable rate of economic growth,
(iii) the fair and equitable distribution of the income and wealth of the nation,
(iv) reasonable price stability and long-term equilibrium in the balance of payments,
(v) the balanced development of all regions in the country, and
(vi) the social implications of economic growth, including the need to protect the environment.

2. The Council may consider such matters either on its own initiative or at the request of the Government.

3. Members of the Government shall be entitled to attend the Council's meetings. The Council may at any time present its views to the Government, on matters within its terms of reference. Any reports which the Council may produce shall be submitted to the Government and, together with any comments which the Government may then make thereon, shall be laid before each House of the Oireachtas and published.

4. The membership of the Council shall comprise a Chairman appointed by the Government in consultation with the interests represented on the Council,

Ten persons nominated by agricultural organisations,
Ten persons nominated by the Confederation of Irish Industry and the Irish Employers' Confederation,
Ten persons nominated by the Irish Congress of Trade Unions,
Ten other persons appointed by the Government, and
Six persons representing Government Departments comprising one representative each from the Departments of Finance, Agriculture and Fisheries, Industry and Commerce, Labour and Local Government and one person representing the Departments of Health and Social Welfare.

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6. The Council shall have its own Secretariat, subject to the approval of the Minister for Finance in regard to numbers, remuneration and conditions of service.

7. The Council shall regulate its own procedure.

NATIONAL ECONOMIC AND SOCIAL COUNCIL

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PART I

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PART I

THE COUNCIL'S COMMENTS AND CONCLUSIONS[1]

In Ireland, two kinds of direct taxation are levied on persons—income tax and social welfare contributions. Incomes are provided or augmented for those judged in need by a variety of social welfare payments.[2] The income tax and social welfare codes have evolved separately, with no obvious links between them.

The present income tax and social welfare codes, even when pay-related benefits and redundancy payments are excluded from consideration, can give rise to a number of problems. For example, the effective tax rate[3] for persons taking up low-paid employment, especially those with large families, can be relatively high. This high effective tax rate is the result of a number of factors, including the following:—

—flat rate social welfare contributions;

—the fall that has occurred in the real value of personal tax-free allowances;

—the relatively high marginal tax rates that are a part of the income tax code;

—the real increases that have occurred in the levels of social welfare benefits and assistance, and

—the absence of any mechanism for transferring purchasing power to workers on low incomes.

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[1]A draft of this report was discussed by the Economic Policy Committee and the Social Policy Committee of the Council, and by the Council at its meetings on 20 October and 17 November 1977.

[2]The various benefits and allowances, and the bases on which they are made available are described in detail in *University and Selectivity in Irish Social Services* NESC, No. 38, forthcoming.

[3]More precisely, the "tax and withdrawal of benefit rate."

As well as creating situations in which some could be no better (or even worse) off as a result of the head of the household taking a job, the present income tax and transfer codes raise other issues.

Little is known of the extent to which they achieve a more equitable distribution of purchasing power among persons or succeed in protecting those without jobs or incomes from poverty. Moreover, both codes are complex and not capable of being easily understood by the population at large.

The Council commissioned Mr. Brendan Dowling of the Economic and Social Research Institute to examine ways in which the system of direct taxation and income transfers might be integrated while resolving these problems and avoiding additional cost to the Exchequer. Mr. Dowling's study is set out in full in Part II of this report.

Mr. Dowling examines three approaches towards integration of the income tax and social welfare codes, namely:—

—a non-refundable tax credit scheme;

—a refundable tax credit scheme;

—an individual grant and tax scheme.

These represent progressively closer approaches to the integration of the two codes.

The non-refundable tax credit scheme would replace the present tax-free allowances and deductions for mortgage interest, superannuation, VHI contributions, etc., by tax credits, substitute a 5% tax on all income earners (including the self-employed) for the present social insurance contributions by employees, and reduce the higher income tax rates. In this scheme, all the changes are concentrated in the direct tax code, with the social welfare code remaining unchanged. Mr. Dowling estimates that the changes proposed would not involve any additional cost to the Exchequer.

In this first scheme, there would be no change in the administration of social welfare payments and the changes proposed in the collection of income and social welfare taxation should not create any severe administration problems. However, the scheme would not help low income families outside the tax net (except marginally by the introduction of income-related social welfare contributions), and it would not reduce the high effective tax rates on low income families returning to employment.

The refundable tax credit scheme is a development of the first. In this second scheme, tax credits are increased and become refundable (that is, those with tax liabilities less than their allowable tax credits receive a refund equal to the difference) and short-term social benefits become taxable (but no tax would be paid by persons in receipt of benefit alone). The refunds of unused tax credits would be confined to those in PAYE employment and to those qualifying under present regulations for social welfare benefits. Tax rates would have to be at higher levels than in the first scheme in order to finance the refunds of "unused" tax credits and the higher level of tax credits. However, Mr. Dowling estimates that despite the higher tax rates, the refundable tax credit scheme would cost between £50 and £55 million more each year than the present arrangements.

The main advantage of the integration of the income tax and social insurance codes within the refundable tax credit scheme is that it reduces the effective "marginal tax rate" on income from low-paid employment, particularly for families with dependent children. Its main disadvantages relate to the treatment of the self-employed and those on social assistance. The self-employed would be left in a somewhat anomalous position, being entitled to tax credits but not to refunds of tax credits. Those receiving social assistance would still suffer high marginal tax rates on moving into employment, though these would be lower than under the present system.

In the third scheme an attempt is made to integrate fully the existing direct tax and social welfare codes. Tax-free allowances, deductions for debt interest, superannuation, VHI contributions, etc. and social welfare and assistance payments are abolished. In broad terms, all persons would receive a cash grant, the size of which would depend on age and employment status. These tax grants would be non-taxable. All income would be subject to direct tax at a standard rate, with a rather higher rate being applied to incomes from self-employment.

In its simplest terms, then, this third scheme would give everybody social welfare payments and tax all incomes at a standard rate. Mr. Dowling estimates that even if all farming incomes were brought within the tax net that it would cost the Exchequer about £83 million more each year than the present arrangements. It would largely avoid or resolve all the problems associated with the existing direct tax and social welfare codes and with the first two schemes he proposes.

It can be seen that the three approaches to integration of the direct tax and social welfare codes examined by Mr. Dowling have two characteristics in common. First, in all of them the existing income tax allowances are replaced by tax credits that have a fixed value in money terms. Second, flat rate social welfare contributions are replaced by income-related contributions which are incorporated in the income tax code. The first two schemes have a third characteristic in common, namely, permitted deductions from income for tax purposes (for example, for superannuation, VHI and life assurance contributions or for mortgage interest) are limited, thus extending the tax base; in the third scheme, no relief would be given in respect of such payments.

In all three schemes, an attempt has been made to ensure that as far as possible no one would lose significantly by a move from the present arrangements to any of the schemes outlined. Apart from the first scheme this makes it impossible to avoid an increase in cost to the Exchequer. As noted above, the second and third schemes would impose additional costs of £50–55 million and £83 million respectively on the Exchequer.

The Council in general accepts Mr. Dowling's analysis of the undesirable consequences that can result from the present income tax and social welfare codes. These consequences could become more serious if the two codes were to continue their separate evolution. It is therefore important that the progressive integration of the present system of direct taxation with the arrangements for income maintenance should be examined. In the Council's view, Mr. Dowling has presented a framework within which discussion (and indeed action) about the relationship between income tax and social welfare could develop fruitfully. These issues have been discussed in many western countries for some time (though as yet without action). It is of the utmost importance that they should be discussed seriously here in Ireland.

Any move towards integrating direct taxation with the arrangements for income maintenance will pose formidable political problems. These are inescapable if the implications of integration for public expenditure are to be kept within reasonable bounds. These problems could be avoided only if none (or very few) were made worse off, and all (or almost everyone) were made better off, as a result of the change. But this situation could be achieved only at excessive cost to the Exchequer. To ensure that the wider debate is as informed as possible, it is very important that the relevant Government Departments should make estimates of the costs involved in the different schemes, because they have much more detailed information at their disposal than had Mr. Dowling when he was making his estimates.

It is also important that the relevant Departments should study in detail the administrative implications of any attempts to integrate the direct tax code with arrangements for income maintenance. While Mr. Dowling has not ignored the problems that could arise in administering his proposals, the Council feels that he may have tended towards under-estimation of the administrative difficulties that could arise in practice.

As well as the cost of any moves towards integration and their administrative implications, there are other problems that would have to be studied in greater detail. For example, more detailed information is required about the implications for those affected of changing from the present cumulative tax basis under PAYE to a non-cumulative basis, as in Mr. Dowling's scheme. Again, it would be necessary to measure the distributional consequences of a *proportional* income tax associated with cash grants to persons (as in Mr. Dowling's third proposal), and compare them with the distribution emerging from present arrangements, which include progressive tax rates. In addition, with the replacement of "tax expenditures" by tax credits (as in the first two schemes proposed by Mr. Dowling), and with the cessation of such taxation relief (as in the third scheme), the Government loses some of its power to guide personal expenditure towards (for example) housing and insurance. The implications of these changes for the building, insurance and other activities merit more detailed examination, as indeed do the implications of an integrated direct tax and social welfare system for the economy as a whole.

Despite the questions to which they give rise, it is the view of the Council that the schemes described in Part II provide a useful basis for discussing the general direction that attempts to integrate the direct taxation and social welfare codes should take. Full integration of the two codes would bring to the surface some of the major issues regarding income taxation and income redistribution which the complexities of the present separate schemes may tend to obscure. As the debate on integration develops, the community would therefore be forced to face, more effectively than at present, the questions of how much redistribution is desired and how much it is prepared to pay for such redistribution. Integration would not merely be a mechanism for doing existing things differently—it could make possible the pursuit and achievement of new and different objectives, and could therefore create a powerful mechanism for bringing about social change. How much social change could be effected would, of course, continue to depend on the amount of resources which the community is prepared to surrender for this purpose.

At the same time, too much must not be expected of any integrated approach, no matter how far reaching it may be. There will always be people who, despite reasonable prudence and foresight, suffer hardship or tragedy that they cannot (and cannot be expected to) cope with on their own. An integrated scheme should not be so inflexible that it prevents a quick response to the needs of such people, if only on a temporary basis.

PART II

INTEGRATED APPROACHES TO PERSONAL INCOME TAXES AND TRANSFERS

by

Brendan Dowling

ACKNOWLEDGEMENTS

Thanks are due to my colleague Professor B. Walsh of the ESRI whose comments on an earlier draft were of great help. The detailed comments of Mr. C. H. Murray were of considerable importance in improving the final draft. Neither are responsible for any errors and omissions that remain.

Brendan Dowling
November 1977

CHAPTER 1

INTRODUCTION

1.1. This study is about personal income taxation, social welfare payments and the relationship between the two. In the following chapters we hope to set out some of the problems caused by the lack of integration of the income tax and social welfare codes and some of the solutions which have been proposed. From an economic standpoint, personal income taxes and personal income transfers are opposite sides of the same coin. From an administrative and policy standpoint, decisions on income tax policy and social welfare policy are usually taken by different agencies with different objectives. This lack of integration of the tax/transfer framework can give rise to consequences unintended by the proponents of specific tax and welfare legislation.

1.2. As our approach is concerned with the personal income tax code and the social welfare code as a single system, it is inevitable that our examination of both taxation and transfer policy will be less than comprehensive. We shall not, for example, examine the appropriateness or otherwise of the structure of taxation; nor shall we examine the many forms, other than direct income transfers, by which the Government distributes resources through the community. A study of the taxation system would be a major undertaking while a study of transfer policies, including transfers in kind, would require a comprehensive examination of the scope, aims and objectives of Government expenditure policies.

1.3. We shall, therefore, confine our attention to personal income taxes (which include contributions to social welfare by employees and employers) and to personal income transfers (which include all social insurance and social assistance payments). Our interest in the personal tax code will centre on those aspects which are important in an integrated tax/transfer framework. We will not deal with other aspects of the tax code with which a more comprehensive examination of the personal tax system would have to be concerned. Similarly, we deal only with those aspects of the social welfare system which are of interest from an integrated approach to taxes and transfers. Thus, there is no attempt here to deal with all aspects of either personal income taxes or social welfare transfers.

1.4. Income taxes create a disparity between the gross and net return to work effort. If an individual has a choice between work and leisure, and we accept that leisure is a desirable good, then as the return to work is reduced the individual will choose more leisure. By taxing the return to work, but not the price of leisure, income taxation tends to encourage the substitution of leisure for work and a reduction in the supply of work effort. Certain factors may, however, offset this tendency to substitute leisure for work in the face of income taxation. One is the institutional practice in the labour market where work is only available in discrete units; an individual might have to work a 40 hour week or not at all. In such cases only those in self-employment have much scope for substituting leisure for work. Another factor, tending to offset the substitution effect of the change in the relative price of work, is the impact of income taxation on disposable income. Individuals, faced with higher income taxes, may seek to maintain their previous level of disposable income and so increase the supply of work effort. In such situations the introduction of income taxation would tend to increase the amount of work supplied at a given gross pay rate.

1.5. The empirical evidence from studies in other countries for the effect of taxation on work effort is less than convincing for either the work effort reduction hypothesis or the income effect assumption.[1] On the other hand, there is a growing body of evidence that the labour supply, or more precisely the level of unemployment, is affected by changes in the level of social welfare benefits.[2] This is hardly

[1]*See Taxation and Incentives* (1976).

[2]*See* Walsh (1977) for evidence on Irish experience.

surprising since the social welfare system, at least as it relates to unemployment, may offset the effect of other institutional constraints which make the choice between work and leisure an all or nothing one. Thus an individual faced with a reduction in the net return to work effort is more likely to choose all leisure (since the labour market does not allow him to reduce the amount of hours supplied per week) when some minimum income level is guaranteed by that choice. The smaller the gap between that guaranteed income level and the post-tax income from work the greater the likelihood that unemployment will be chosen.

1.6. Of course, individuals may have varying attitudes to work and leisure and so low net returns to employment could lead in one case to higher effort, perhaps through more overtime, to achieve an income target, while in another case it might result in voluntary unemployment. A married man with six children who is offered the choice between employment at £50 p.w. after social insurance contributions and income tax and unemployment benefit of £41·45 may decide that the return to work (which for a 40 hour week would be only about 21p per hour before allowing for work-related expenses such as transport, meals away from home etc.) does not justify accepting employment. On the other hand, the increase in income, however small, might lead to a ready acceptance of the job-offer. But economic theory, common sense and an increasing body of empirical evidence suggests that the existence of social welfare benefit or assistance transfers which are high relative to alternative after tax incomes from employment will tend to reduce the labour supply and increase measured unemployment.

1.7. It is possible that some families would actually be worse off if the male head of the household sought employment rather than remained unemployed. This was especially the case after the introduction of pay-related benefits and prior to the rule which limited benefit from all sources including tax refunds to 85% of previous net pay. This rule has undoubtedly reduced the number of cases where individuals would be better off out of work than in employment at their previous wage. However, it has not entirely eliminated the possibility of "poverty traps" where larger families, with poor income prospects, are unlikely to improve their circumstances if the male head finds employment. This is because the 85% rule does not apply to flat rate benefit or assistance payments. These payments are not taxable and so any earnings by a wife, for example, can be set-off against available tax-free allowances. In addition the costs incurred by taking up employment may not be negligible. There is also the possibility that other means-tested transfers may be reduced if income is obtained from employment rather than from benefit or assistance. An example of this would be the differential rents scheme which only takes account of half of social welfare payments compared to all of income from employment. It must, however, be conceded that the range of transfers outside the social welfare system likely to be affected is small and the main problem lies in the relationship between income taxes and transfers.

1.8. The problem of "poverty traps" or of low net returns to employment can arise from the operation of the personal income tax code, from the operation of the social welfare system or from both. On the income tax side the important factor is the rate of taxation likely to be faced by the average worker. In the past decade and a half we have seen a massive expansion in the numbers in the tax net. A very significant proportion of the growth in income tax revenue has come from tax levied on employee incomes. In addition there has been a sustained rise in the real burden of social insurance contributions. Today it is unlikely that many wage and salary earners remain untouched by the income tax system; rather, most are vitally interested in, and affected by, changes in the tax code. The growth in the tax base and the extension of income taxation to all but the lowest paid worker has been due, in part, to rising real incomes. Since 1960 real average employee incomes have about doubled. With any progressive income tax system it is inevitable that rising real incomes will result in an increasing tax burden. In addition, the failure to adjust the income tax code for the effects of inflation over the years has resulted in a marked increase in the real tax rate. Of course this increase in the income tax burden could have been legislated for in the absence of inflation. But it is likely that greater public resistance to such increases would have emerged if legislation had been required to effect the changes which inflation has brought about.

1.9. From the point of view of work incentives both the average rate of tax and the marginal rate (i.e. the proportion of any increase in income taken in tax) are important. A high average tax rate, in conjunction with untaxed unemployment benefits, may reduce the rewards to being employed relative to unemployment quite significantly. On the other hand, a high marginal tax rate may reduce the incentive to increase the supply of hours worked by those in employment. Both are important aspects of income tax policy although our emphasis will be mainly, but not wholly, on the average tax rate likely to face a typical worker. In a progressive tax system (i.e. one where the average rate of tax rises as income increases) the marginal tax rate will lie above the average rate. Broadly speaking the Irish tax code is progressive although the flat rate social insurance contribution can result in considerable anomalies. Thus, for example, a single person earning £30 per week from insurable employment would have the same average tax rate as a single self-employed individual earning £42·38 per week.

1.10. It is important to disinguish between the nominal progressivity of the tax code and the actual progressivity. The latter depends on the extent to which higher income tax payers have greater expenditures on tax-exempt items like superannuation, life assurance, voluntary health insurance, mortgage and other debt interest and a greater number of eligible dependents (possibly bcause of a higher participation in second and third level education rather than larger completed families). It is not sufficient to look at the increasing tax rate, as taxable income rises, in order to ascertain the effective progressivity of the income tax system.

1.11. The average tax rate will be influenced by the income tax code, by the level of social insurance contributions, if any, and the method by which they are levied, by the extent to which certain tax-exempt expenditures are incurred and by the level of personal tax-free allowances. Thus a tax payer who has a high income but has a high level of tax-free allowances and considerable expenditure on mortgage and consumer debt interest and superannuation contributions might well have a relatively low average tax rate. On the other hand, the marginal tax rate could be very high in relation to the average rate.

Thus a married man with three children earning £3,820 p.a. with interest and other tax-exempt payments of £500 p.a. would, assuming he was self-employed and paid no insurance contribution, have an average tax rate of only 9·2%. On the other hand, he would face a marginal tax rate of 35%. In the case of a worker in insurable employment with a similar income and level of deductions the average rate would be 13·7% while the marginal rate would also be 35%. For both tax payers the discrepancy between the average and marginal tax rates is considerable.

1.12. The level of Social Welfare payments, relative to average wages and tax thresholds, and their treatment for tax purposes are significant in any examination of the impact of tax/transfer systems on work incentives. In this study we shall not be concerned with the pay-related and redundancy components of income maintenance transfers. This is because this area has been extensively studied in recent years.[1] It has also been argued recently that only about 20% of those registered as unemployed receive pay related supplements.[2] In addition the operation of the 85% rule in respect of redundancy and pay related supplements greatly reduces the scale of the problem caused by those particular payments. By confining our attention to flat rate payments we are indicating that the problems of "poverty traps" and work incentives are not confined to pay related supplements.

1.13. By concentrating on flat rate payments we also avoid having to make assumptions about recipient's previous employment income and the duration of unemployment experienced. The only factors which affect the flat rate payments are the legislated levels, the category of payment (i.e. whether it is assistance or benefit, and for old-age, disability or unemployment etc.) and the number of dependents of the recipient. It is this latter which has the most profound influence on the level of payment and which is of special interest in any study of the position of Social Welfare payments relative to earnings and

[1]*See* Walsh *op cit* and Whelan and Walsh (1977).

[2]*See* Murray (1977).

the tax code. For, in general, employers do not pay wages differentiated by the dependency responsibilities of employees.[1] Therefore, while State income maintenance payments will reflect the extent to which the recipient has financial responsibilities towards dependents, alternative employment income will not. Clearly there is the possibility of poverty traps for families with a number of children and low earnings potential.

1.14. The problem may be compounded by the tax treatment of short-term social assistance and benefit payments. These are treated as non-taxable in the hands of the recipient. It might be felt that if the sums made as payments would not, of themselves, be liable to tax then no great problem arises from treating them as non-taxable in principle. But this ignores the cumulative nature of the PAYE tax system whereby individuals are taxed each week or month as if their average weekly or monthly payment for the start of the tax year would continue for a full year. Thus when a worker becomes unemployed tax refunds are payable because the Revenue authorities assume that there is no income from the moment of unemployment. The existence of such refunds can lead to short-term anomalies in the relationship between take home pay from employment and income from Social Welfare payments and tax refunds. The non-taxability of benefit payments is also important in cases where there is a working spouse since the spouse can claim all tax-free allowances against a single income.

1.15. It must be stressed that our concern in this study is with the income tax/income maintenance transfer system as a single system designed to effect the redistribution of resources between groups within the community and to make some net contribution to the costs of other Government programmes. Thus we are not concerned to establish whether income taxes or Social Welfare payments are too high or too low; nor are we dealing with the extent to which fraud or non-compliance creates a divergence between the actual experience with respect to taxes and transfers and the legislation. We are

[1]Indeed the move to equal pay, based on the payment of the marriage differential to single persons, has virtually eliminated all dependancy related wage and salary payments in the Public Sector.

conscious that we are dealing with a subset of total taxes and total transfers and that policies concerning income taxes and income transfers cannot always be viewed in isolation from the whole tax and transfer framework.

1.16. A policy which laid stress on the importance and efficiency of market prices and the freedom of the individual to allocate available resources among different goods might well have a transfer system which concentrated entirely on redistributing income through cash payments which could be used to purchase housing, healthcare, education etc. at market, unsubsidised, prices. Another policy might put greater emphasis on the public provision at zero cost to the consumer of services like health, education and housing and on the subsidisation of important basic items such as food and transport. Inevitably the level of cash transfers in the second case would be far below that of the market-orientated approach although the amount of real resources made available to the transfer recipient might not be much different.

1.17. Similarly, there is a choice between tax systems which depend heavily on income taxation, including social security contributions, and those which rely on indirect taxes. For a given level of revenue the tax system which depends on income taxation is likely to have fairly low indirect taxation and *vice versa*. The choice of tax system may also affect the level of transfers in that a high dependence on indirect taxes would mean that the value of income maintenance cash transfers would have to be higher in order to compensate for the higher price level.

1.18. Although the income tax and income maintenance system is only a part of the wide set of taxes and transfers, it does seem worthwhile to examine it separately. In the first place, the primary objective of the tax and transfer system is to redistribute resources. Thus income taxes are designed to remove some proportion of an individual's income and transfer it to the Exchequer. Similarly, income maintenance payments are intended to transfer income from the Exchequer to individuals in the community. Even if the administration and design of the two systems are handled entirely separately it is clear that both

deal in resource transfers measured in terms of money. On the other hand, transfers in kind, such as the public provision of health, education, and housing, may have the objective of altering the community's consumption of specific commodities rather than of redistributing resources.

1.19. So, while recognising the interdependence of the economic system we do not feel that we should become prisoners of this interdependence to the extent that no study becomes possible unless it is a vast project examining the system as a whole. In dealing with personal income taxes and transfers we are dealing with an important component of public sector revenues and expenditure. In Table 1.1 we have set out the value of all subsidies, current transfers from public authorities and capital transfers to households and enterprises. We have also set out the amount of subsidies, transfers and grants made to the health and education sectors. We eliminated this amount from the total because of the belief that these are not, strictly speaking, transfers and arise mainly because of the organisational structure of education and health care in this country. These transfers etc. should, more properly, be analysed in the context of all Government spending on health and education including direct purchases of goods and services. The remaining level of transfers, subsidies etc. are set out in Table 1.1 and the share of current transfers in this total is also set out. It can be seen that this share rose very sharply in 1973/74 and continued to rise to 1975. Part of the increase is accounted for by the decline in the role of agricultural subsidies after EEC entry and part by the rapid increase in the levels of social welfare transfers. The bulk of the current transfers (when health and education are excluded) are in respect of social welfare payments, although there are certain transfers in kind (including free electricity, TV licences, etc., for old age pensioners). Thus in dealing with social welfare transfers we are covering a significant proportion of the total public expenditure on transfers, subsidies and capital grants.

1.20. By looking at the personal tax and transfer system as an integrated whole we can ask the question: how much does the system provide to finance other Government expenditure? In other words, if we suppose that income tax receipts went directly to an agency which used them to finance income maintenance payments we would want to know what funds, if any, the agency would have surplus to its requirements. In this way we can distinguish between the net amount of income taxation levied on the community as a whole and the gross amount. The net amount is equal to income tax levied less social welfare payments received. Of course, for most individuals liable to income tax, the net and gross taxes paid are likely to be the same; but aggregating for the community yields a net figure for the population viewed as a single tax payer.

1.21. Why do we need this net figure? The main reason is that alternative integrated approaches to the tax/transfer system must still meet the Government financing constraint i.e. they must deliver an

TABLE 1.1

Subsidies, Current Transfers and Capital Grants etc. 1970–71 to 1975

£ million	1975	1974	1973–74	1972–73	1971–72	1970–71
Subsidies	137·2	98·4	83·8	95·1	86·4	79·2
Current Transfers	487·9	343·3	276·0	208·4	175·6	148·6
Capital Transfers	69·7	55·9	48·0	48·8	51·7	40·5
Total	694·8	497·6	407·8	352·3	313·7	268·3
Health and Education	113·2	84·5	70·2	55·7	41·3	34·5
Total (excluding Health and Education)	581·6	413·0	337·6	296·6	272·4	233·8
As a percentage of Total Subsidy, Transfer and Grant Expenditure						
Subsidies	23·6	23·8	24·8	32·1	31·7	33·9
of which Farm	*5·5*	*8·6*	*9·3*	*19·4*	*21·4*	*20·0*
Current Transfers[1]	66·8	65·8	63·9	54·4	51·9	51·4
Capital Grants[1]	9·6	10·4	11·3	13·5	16·4	14·7

[1]Excluding Health and Education.
Source: National Income and Expenditure 1975.

equivalent net amount to the Exchequer. We assume that the level of personal taxation is set by the Government so as to yield a particular net amount of revenue after payment of social welfare transfers. It is not very important for our purposes whether in fact decisions on income taxes are taken like that. Unless one wishes to make the argument that income tax rates are determined in an entirely random fashion, without reference to expenditure commitments in social welfare or elsewhere, it must be presumed that income taxes are levied *as if* they were to ensure a particular net yield to the Exchequer from the tax/transfer system. To a certain extent the decision-making process which links income maintenance payments to direct taxes is explicit in that the level of social insurance countributions is heavily influenced by the level of financing required for social welfare benefit payments. Although the State contribution to the cost of benefit payments may vary from year to year as a proportion of total expenditure it is, broadly speaking, the objective to ensure that increases in transfer levels are matched by proportionate increases in social welfare contributions. Only to that extent, however, does the present system involve an explicit hypothecation of revenue, i.e. the use of a particular tax revenue for a particular expenditure purpose.

1.22. It should be clear that an integrated approach to personal income taxes and transfers does not involve any necessary hypothecation of revenue. The Government would still set the tax level to ensure that the net amount of resources it required from the system were made available. A decision to rely more on direct, than indirect, taxation could involve an increase in income taxes so that the amount available from the tax/transfer system for other expenditure was increased. On the other hand, a policy which wished to shift taxation from income to expenditure could involve net payments to the income tax/transfer system from the Exchequer. In short an integrated approach to income tax and income maintenance transfers does not involve the explicit, and exclusive, linking of income tax with transfer spending. It is no part of the argument that revenue from income taxes must be devoted exclusively to income transfers; nor, alternatively, is it held that expenditure on income maintenance transfers must be wholly financed by taxes on personal income. The need for integration arises from the possible interaction of the social welfare and tax codes and the impact on work incentives. An integrated approach would ensure that changes in one particular code, whether social welfare or taxation, were evaluated within a total income tax and transfer framework. From an Exchequer budgeting viewpoint what matters is the net cost of, or net revenue from, the system. Of course the manner in which that net cost is incurred, or net revenue raised, is important for the supply of labour and for the economic well being of the community as a whole.

1.23. It is somewhat surprising to find that the Exchequer does not depend very heavily on net revenue from the income tax/transfer system taken as a whole to finance other activities. In Table 1.2 we have set out for the period 1965–1977 the total amount of revenue raised from direct taxes on personal income (i.e. income tax and social insurance contributions by both employers and employees) and the total amount transferred to persons by the State. These latter transfers exclude transfers in kind such as health care, education including school transport, and concessions such as free travel for old age pensioners. They thus represent mainly cash transfers. From this we can see that the net amount of tax raised from the entire tax/transfer system has been, in general, quite small relative to Government spending, other taxes or personal income before taxes and transfers. The gross amount of tax raised is much larger but is offset by the flow of resources back to the personal sector in the form of cash transfers. From the Table it is clear that in 1976 and 1977 the level of net taxes rose sharply after a relative decline in 1974 which was maintained in 1975. These movements owed much to the sharp rise in transfers in this period due to improvements in real transfer rates and the cyclical response of aggregate transfer expenditure.[1]

1.24. The data in Table 1.2 would suggest that only a relatively small amount of resources is required from *net* income taxation to finance other Government expenditures or supplement other taxation.[2] In 1977

[1]*See* Walsh (1974) for a discussion of the relationship between transfer expenditures and overall economic activity. The impact of the recession on direct tax revenues would also have tended to reduce the net revenue raised during the 1974–1975 period.

[2]We ignore of course the question of whether more Government revenue is required to finance even the existing levels of expenditure.

TABLE 1.2

Personal Income Taxes, Personal Transfer and Net Taxes, 1965–77.

Year	(1) Taxes on Personal Income	(2) Personal Transfers	(3) = (1) − (2) Net Income Tax	Net Income Tax as Percentage of: Current Government Spending	Other Taxes	Personal Income[1]
	£ million	£ million	£ million	%	%	%
1977[2]	760·0	520·0	240·0	15·02	24·12	5·45
1976[2]	629·0	465·0	164·0	12·78	19·88	4·44
1975	459·0	376·6	82·4	7·73	13·47	2·56
1974	323·9	263·3	60·6	8·11	11·55	2·39
1973	279·0	209·4	69·6	11·47	14·66	3·12
1972	219·1	156·2	62·9	12·28	16·06	3·46
1971	189·5	136·9	52·6	12·32	15·34	3·48
1970	134·7	116·9	17·8	4·85	5·62	1·34
1969	108·5	96·2	12·3	4·01	4·52	1·06
1968	94·8	80·1	14·7	5·62	6·58	1·43
1967	83·3	71·7	11·6	5·11	5·94	1·29
1966	69·7	66·1	3·6	1·82	2·02	0·43
1965	57·8	58·4	0·6	−0·03	−0·04	0·08

[1]Excluding personal transfers.
[2]Estimated.

Note: Personal Transfers are obtained from Table A.20 of the *National Income and Expenditure* 1975 as are transfer payments (excluding national debt interest) to households and private non-profit institutions by public authorities (less health, education transfers and transfers in kind). Data for 1976 and 1977 are derived from Budget information.

Source: National Income and Expenditure 1975: *Budget* 1977.

net income taxes absorbed only 5½% of personal income before taxes and transfers and generated only about 15% of the resources needed to finance current Government spending, net of personal transfers. For much of the period the tax/transfer system appeared as a relatively closed system with little dependence on, or contribution to, other tax revenue.

1.25. It is of interest to examine whether this low dependence on net income taxation from the personal sector as a source of Exchequer finance is peculiar to Ireland or whether it is a common feature of most developed economies. In Table 1.3 using a broader notion of income taxation (including company and wealth taxation) and social benefits (including transfers in kind) we can see that, in 1974, of all EEC countries Ireland had the smallest net contribution from income taxation as a percentage of Gross Domestic Product. At first one might suppose that this reflected the high Irish dependency ratio with a consequent pressure on the relative level of social expenditure. In fact this is not the case since the Irish expenditure on social benefits as a proportion of GDP is lower than any other EEC country with the exception of the United Kingdom. The reason for the low level of net

TABLE 1.3

Income and Social Security Taxes and Social Benefits as a Share of Gross Domestic Product in Certain EEC Countries, 1974

Country	As a Percentage of Gross Domestic Product, 1974			
	Income Tax (1)	Social Security Tax (2)	Social Benefits[1] (3)	Net Income Taxes (4) = (1) + (2) − (3)
	%	%	%	%
Belgium	14·86	12·39	18·05	9·20
France	7·41	13·59	17·70	3·30
Germany	12·90	12·85	19·54	6·21
IRELAND	*10·23*	*4·40*	*11·75*	*2·88*
Italy	6·68	13·08	16·81	2·95
Luxembourg	16·98	11·17	15·37	12·78
Netherlands	15·99	18·16	22·17	11·98
United Kingdom	15·77	6·42	9·73	12·46

[1]Provided by the public authorities.

Sources: Table 8.2 for member countries in *National Accounts ESA 1970–1975* Eurostat 1976. Social Benefits include transfers in kind and pensions paid to retired public servants. The latter tends to overstate the share of Social Benefits in GDP for all countries. As the Irish payments of public service pensions as a % of GDP are among the highest in the EEC, exceeded only by France and Germany, the broad picture presented above would not be altered by the exclusion of public service pensions.

contribution from the taxation of incomes is clear from Column (2) of Table 1.3 where Irish social security taxes are the lowest as a proportion of GDP. Income tax as a proportion of GDP is also relatively low, reflecting either lower tax rates or lower income levels for a given progressive tax code,[1] but the major discrepancy lies in social security taxation. Part of the explanation may lie in the structure of the Irish population with, relatively, the highest proportion of self-employed persons in the active population but, as we shall see, much of the explanation is due to the relatively low level of social insurance taxation.

1.26. For our purposes the low dependence on net income taxation is advantageous in that it makes consideration of alternative, integrated tax and transfer schemes somewhat easier. If relatively large amounts of resources were being transferred from the personal sector to general government revenues and thence to general expenditure it would be difficult to design an integrated tax/transfer system which was not costly, in terms of revenue loss, or undesirable, in terms of high marginal tax rates. As we shall see later, reform of tax laws tends to be an expensive business if only because of the need to compensate those who lose from any changes in the tax code.[2]

1.27. However, before we can go on to consider some alternative integrated approaches to income taxation and personal income transfers, we shall have to examine our existing tax and social welfare structure. From this examination we shall, hopefully, be able to discover the difficulties to which the lack of co-ordination between the two systems can give rise. Chapter 2 contains an analysis of some aspects of our existing tax and social welfare system. In Chapter 3 we consider some general features which should underlie any integrated approach to the tax and transfer system. In Chapter 4, 5 and 6 we set out alternatives, varying in complexity and the degree to which the present code would have to be changed. In Chapter 7 we draw some general conclusions about the integrated approach to income taxation and Income maintenance.

[1]It may also reflect the special tax treatment of farm incomes which account for a higher proportion of GDP in Ireland than in the rest of the EEC.

[2]Readers interested in the general theory of tax reform should see Feldstein (1976).

CHAPTER 2

THE PRESENT INCOME TAX AND TRANSFER SYSTEM

2.1. In this Chapter we shall be concerned with some aspects of both the income tax system and the social welfare code which are relevant to any integrated approach to taxes and transfers. More particularly we will be concerned with the extent to which the two systems are related; the degree of progression in the income tax code and the possibilities of offsetting such progression with tax exempt expenditure; the nature, extent and progressivity, or otherwise, of the social insurance tax system; the relationship of social welfare payments to earnings and the problems created by high dependency levels; and the extent to which significant increases in incomes are possible for those moving from social welfare payments into employment.

2.2. One of the difficulties inherent in examining the income tax and social welfare codes in an integrated manner is that there is no obvious link between the two systems. Indeed prior to the introduction and collection of pay-related social welfare contributions the administrative links between the two systems were slight. One possible way in which the two systems might be linked is through the level of personal tax-free allowances in the income tax code. If these were to represent some notion of a minimum income level, which should not be taxed, then we might expect that the social welfare system, which is designed to deal with questions of income adequacy, would reflect similar minimum income concepts. We do not know how the tax-free allowance levels are derived. But if they are meant to represent minimum income levels then it is reasonable to assume that they would have, at least, to remain constant in real terms over time. Indeed since poverty, and the definition of a minimum income, is partly a relative concept one might expect that the value of tax-free allowances would have kept pace with average incomes.

2.3. In Table 2.1 we have set out the relationship between tax-free allowances and industrial earnings (for males) for selected years from 1955 to 1977. There we can see that the level of tax-free allowances has fallen sharply relative to earnings since 1955, and more especially since 1960/61, when allowance levels were increased in order to compensate for a changeover to PAYE taxation. It is clear that if tax-free allowances embody some notion of minimum income levels these levels are absolute and not relative to average earnings in the community. Indeed, it is clear that for all taxpayers the required minimum income level, implicit in the tax code, has fallen quite sharply since 1960/61. Thus the real value of the single person's allowance has fallen by 30% since 1960/61, the married couple's allowance by a similar amount, the married couple with two children suffered a real fall in allowances of 38%, while a couple with four children had a real decline of 41%. Only single persons had allowances in 1977 equal, in real terms, to the value of such allowances in 1955, prior to the introduction of PAYE. Whatever the origins of the tax-free allowance concept, the present position would seem to have evolved in a quite arbitrary manner and it cannot be inferred that the level of tax-free allowances represents some objective minimum level of income required by individuals or families.[1] This is hardly a surprising finding as there is no procedure, in the present tax code, for a transfer or grant to be automatically paid by the Exchequer to bring the low income individual up to the level of his tax-free allowance. Thus in spite of the superficial resemblance between tax-free allowances and objective measures of poverty line income levels we must view the tax-free allowance structure as an integral part of the progressive income tax code, where the levels are determined independently of any view about minimum income levels.

2.4. The Irish tax-free allowance structure, relative to average earnings, does not appear especially out of line in comparison with other OECD countries which use tax-free allowances as an integral part of the income tax code. This can be seen from Table 2.2 where

[1] O'Muircheartaigh (1976) shows that much of the variation in the real value of allowances over the post-war period has been due to varying treatment of tax allowances for child dependants in the income tax code.

C

TABLE 2.1

Tax free Allowances as Percentage of Average Male Industrial Earnings and in Real Terms, Selected Years 1955 to 1977

	Single Persons		Married		Married with 2 children		Married with 4 children	
Year	A	B	A	B	A	B	A	B
	%		%		%		%	
1977[1]	17·5	101·3	29·0	83·7	41·6	77·2	54·3	67·2
1976	18·1	108·2	29·5	88·0	43·6	77·9	57·6	73·6
1975	19·8	118·4	31·7	94·6	47·5	85·2	63·4	81·1
1970	26·8	95·8	45·6	81·5	76·2	80·1	106·8	81·9
1965	43·4	116·3	73·1	97·8	117·6	94·4	162·2	93·0
1960	61·3	143·1	103·3	120·4	166·2	116·2	229·1	114·4
1955	50·1	100	100·2	100	166·9	100	233·6	100

1. 1977 earnings of £73 per week.

A: Tax-free allowances as percentage of average male industrial earnings (normally taken in September/October inquiry).

B: Real value of allowance with 1955 = 100.

Note: In 1974 Earned Income Relief was abolished and incorporated into the allowance and rate structure. Thus for a more precise comparison (for earned income) the values for years prior to 1975 ought to be multiplied by a factor of 1.33 i.e. an individual could have *earnings* of 1.33 times the personal allowance before being liable to tax.

the Irish tax-free allowances relative to earnings are compared with those of eight other OECD countries and compare quite favourably. Only in the United Kingdom and the United States (where a standard taxpayer deduction is assumed) are the relative allowances fairly consistently greater for taxpayer classes. Of course, many countries do not use tax-free allowances as prior deductions from taxable income as a component of the income tax structure. In Belgium, tax credits (i.e. allowances for tax otherwise due) are given for married persons and dependent children. In France a proportionate deduction (with a minimum) is granted plus the use of the "quotient familial" system where total income is divided by a number of units (one unit each for husband and wife, 0·5 units for a child) and the tax

attributable to the income so divided is multiplied by the number of units to give tax payable. In Italy tax credits are used instead of allowances. The use of tax credits tends, as we shall see, to confine tax relief in respect of dependent children to a fixed cash amount whereas with tax-free allowances the value of a dependent child or spouse can vary from zero (if the allowance is unused) to the highest marginal tax rate times the allowance for the upper income taxpayer. The French system tends to reduce significantly the tax burden for high income taxpayers with dependents, because the division of income by family quotients sharply reduces the progressivity of the tax system with respect to family income (although not with respect to weighted *per capita* income).

2.5. Although the evidence over time does not support the view that tax-free allowances are based on an assessment of required minimum incomes, they are an essential part of the progressive structure of taxation. Personal allowances are subtracted from gross income before taxable income is calculated. Thus over significant ranges of income the average tax rate rises quite slowly, although the marginal tax rate may be relatively high. It is possible for a tax code with no personal allowances but with low tax rates to impose lower tax burdens on most taxpayers than a tax code which had generous tax-free allowances but high marginal tax rates. The latter code would, however, tend to act as a disincentive to increased work effort because of the high marginal rates. Thus an examination of personal allowances across countries or within a country cannot tell us much about the tax code as a whole. It is therefore of interest to examine the progressivity of the tax codes in other countries to see whether the existence of high tax free allowances implies steep progressivity. It is, of course, quite difficult to compare different tax codes with different tax rates and ranges over which they apply. However, it seemed useful to attempt, crudely, an examination of progressivity without having to convert earnings in different countries into purchasing power equivalents or to resort to a stylised "typical" taxpayer.

2.6. One approach was adopted which gives some measure of tax progressivity when combined with information about upper and lower tax rates; this was the multiple of average earnings in industry which

TABLE 2.2

Tax Free Allowances as a Percentage of Average Male Industrial Earnings in 1974

Country	Single	Married	Married with 2 Children	Married with 4 Children
	%	%	%	%
Canada	18·7	34·2	40·8	47·4
Denmark	13·1	26·2	26·2	26·2
Germany	11·5	19·1	31·9	48·0
IRELAND[1]	22·6	36·2	54·3	63·3
	(17·5)	(29·0)	(41·6)	(54·3)
Japan	—	9·7	27·8	46·0
Netherlands	19·4[2]	32·6	37·0	40·2
United Kingdom	24·6	34·1	53·0	74·6[3]
United States	22·5	30·7	47·2	63·7

[1]Figures in parentheses refer to 1977.
[2]Assumed under 35.
[3]Two children under 11, two between 11 and 16.
Note: In Germany the tax treatment of children has been radically altered since 1974 by the substitution of cash transfers in place of tax-free allowances for children.
Source: OECD (1977) *The Treatment of Family Units in OECD Member Countries under Tax and Transfer Systems.*

corresponded to the range between the upper limit of the first tax rate bracket and the lower income limit of the highest tax rate. The range between tax brackets is in terms of taxable income which depends, *inter alia*, on the level of personal allowances. However, by confining our attention to the gap between the upper limit of the first tax bracket and the upper tax bracket we effectively avoid the problem of varying tax-free allowances.[1] In table 2.3 we have set out the data for eight EEC countries in 1974. In the Netherlands, for example, the gap between the upper limit of the lowest rate and the lower limit of the highest tax rate is 5·4 times the average industrial earnings. Thus the tax structure in 1974 in the Netherlands allowed

[1]However the lowest marginal tax rate (i.e. the rate applicable to the first band of taxable income) may be affected by the treatment of tax-free allowances. So comparisons between France and the Netherlands (or Ireland) may be unfair if based on the lower tax rates.

a gap between the two extreme tax rates of quite a high multiple of average earnings. In contrast the speed with which increases in income move a taxpayer from the low to the high tax rate is particularly pronounced in Denmark where an increase in income only slightly in excess of average industrial earnings would push the taxpayer on the limit of the lower rate into the highest tax bracket. It is noticeable that, Denmark apart, the Irish range in 1974 was smaller than in any other EEC country. Also, the upper income tax rate, at that time, was the second highest in the Community; since 1974 the range has narrowed further to only 1.7 times average earnings but the upper and lower tax rates have been reduced. Thus in Ireland the gap between the low and high tax rates has narrowed very sharply from an already relatively low position although this has been offset to some extent by a reduction in the rates. Although changes in tax rates make comparisons difficult between tax years it must be noted that the width of the 35% tax band has fallen in real terms by about 53% since 1974 while the upper limit of the 50% bracket has fallen in real terms by 48% since 1974. Thus a fall in the real value of tax brackets has accompanied the fall in the real value of tax-free allowances. Inflation has led to a greatly increased progressivity of the income tax system in Ireland which, even in 1974, had a relatively narrow income gap between the upper and lower tax rates.

2.7. From an examination of those countries that are in both Table 2.2 and Table 2.3 we see no immediate evidence that countries with high tax-free allowances have steeply progressive tax rates. Of course, it is possible that our use of the range between upper and lower tax rates might be misleading in that tax codes could have wide bands for lower tax ratês and very narrow bands for upper rates (or *vice versa*) for any given overall range. This might, for example, explain some of the disparities between the Irish range and most other EEC countries. It is not the whole answer as a comparison of the 1977 Irish tax rate structure and the 1974 Netherlands structure indicates. As Table 2.2 shows the level of allowances in the Netherlands is not significantly inferior, relative to average earnings, than that in Ireland. In Table 2.4 we set out the width of the brackets for the various tax rates in the two countries. These are expressed as a proportion of average earnings and the cumulative levels are also shown.

TABLE 2.3

Range between Upper Limit of Lowest Tax Bracket and Lower Limit of Highest Tax Bracket as Multiple of Average Male Industrial Earnings, 1974

Country	Ratio of Range to Average Earnings	Lowest Tax Rate	Highest Tax Rate
Belgium	14·5	30*	66
Denmark[1]	1·1	32·4/41·4	57·0/66·0
France	3·4	5	60
Germany	4·6	19	53
Italy	207·5	10	72
Netherlands	5·4	25	71
United Kingdom	6·1	33	83
IRELAND[2]	3·1	26	80
	(1·7)	(20)	(60)

*Second band tax rate; rate on first band varies with family circumstances.

[1]The range in tax rates is due to the effect of local taxes which vary from 16 to 25 per cent depending on the locale.

[2]Figures in parentheses are for 1977 with industrial wage of £73 per week.

Source: OECD (1977) *op. cit., The Impact of Rising Prices on Taxation and Social Security Contributions in the European Community*, Commission of the European Communities, Economic and Financial Series 12 (1976).

2.8. The compressed range of the Irish tax code stands out quite clearly. However, the treatment of those in the lower tax bracket is quite similar; the 20/25 per cent tax rate applying to taxable income up to around 40% of the average male industrial earnings in Ireland and 45% in the Netherlands. The Irish rate jumps more severely to 35% compared to 31% in the Netherlands but the width of the 35% bracket far exceeds the Netherlands 31% bracket so that persons with taxable incomes slightly over 1·09 times average earnings would face a marginal tax rate of 49% in the Netherlands compared to 35% in Ireland. The major difference lies in the fact that at the higher tax rates in the Netherlands the bracket widths tend to increase while the rate progressivity slows down. In contrast the Irish tax brackets first widen then narrow so that middle-income tax payers could face sharp jumps in marginal tax rates without very large income increases. The 1974 position was more favourable for Ireland in that the upper

end of the 35% bracket was reached only when income equalled almost twice average industrial earnings. By contrast in the Netherlands the 49% bracket was reached when taxable income exceeded 1·09 times earnings. Of course changes in the Netherlands since 1974 may have made the relative position better for Ireland (or worse). The advantage of the comparison here is to illustrate that some features of the Irish tax code are not necessarily wholly attributable to the use of tax-free allowances as a part of general income tax policy because the Netherlands position with respect to allowances is so similar to ours.

2.9. If tax-free allowances are not based on minimum income concepts and are simply part of the progressive tax structure then the question arises as to whether we could have alternative tax systems which did not have tax-free allowances. For example, without tax-free allowances we might be able to avoid the sharp discontinuities that occur when there is the possibility of total exclusion from income taxation combined with high and sharply rising rates for those in the net. The acceptability of a tax code which taxed even low incomes but which had lower tax rates on marginal income and a smoother degree of progression in the average tax rate would depend on whether income supplements etc. were available to those on low incomes. We can see that a system of tax-free allowances tends to reduce the amount of tax payable by a high income tax payer far more than the amount saved by a low income tax payer. Thus a £100 allowance can be worth as much as £60 in terms of tax saved to a taxpayer at the highest marginal rate and only £20 to an individual being taxed at the highest marginal rate. Indeed, for those with very low incomes, who would not be in the tax net even without the particular allowance, the allowance is worthless. No grant is paid to taxpayers whose incomes are below the combined value of the tax-free allowances available to them. Tax-free allowances sharply reduce the extent to which total income is reflected in taxable income. As we can see from Table 2.5 almost one third of gross income reported for tax in 1974/75 was absorbed by claims for tax-free allowances. Put crudely the abolition of tax-free allowances would have allowed a reduction in tax rates by a third in 1974/75. Before we can explore alternative structures, however, we shall have to continue our examination of the tax and social welfare code.

TABLE 2.4

Comparative Tax Brackets and Rates for Ireland and the Netherlands

Ireland 1974			Ireland 1977			Netherlands 1974		
	As a % of Avg. male Industrial Earnings			As a % of Avg. Male Industrial Earnings			As a % of Avg. Male Industrial Earnings	
Tax Rate %	Bracket Width	Cumulative	Tax Rate %	Bracket Width	Cumulative	Tax Rate %	Bracket Width	Cumulative
26	70·1	70·1	20	13·2	13·2	25	45·0	45·0
35	126·6	196·7	25	26·3	39·5	31	29·1	74·1
50	90·5	287·2	35	79·0	118·5	39	34·9	109·0
65	90·5	377·7	45	39·5	158·0	49	52·3	161·2
80	Balance		50	26·3	184·3	58	63·9	225·1
			60	Balance		63	75·5	300·7
						66	93·0	393·6
						69	185·9	579·6
						71	Balance	

Source: As for Table 2.3. Average male industrial earnings for 1977 taken as £73 per week.

2.10. The personal tax-free allowances are not the only source of erosion of the income tax base and in the light of the falling real value of allowances and rising real incomes they are likely to become less important. At the personal income tax level major sources of erosion are expenditure items which are allowable for income tax purposes. Thus certain forms of expenditure, notably mortgage and other interest payments, superannuation contributions and Voluntary Health Insurance premia are allowable as deductions from gross income before tax is levied. These tax concessions have become known in the public finance literature as "tax expenditures" as they replace the need for Governments to subsidise the activities for which tax concessions are granted. The main criticisms of tax expenditures centre on the lack of explicit calculation of the cost, in terms of foregone revenue, of these concessions and the consequent need to recover the lost revenue through higher tax rates on the income remaining in the tax net. Other critics argue that tax concessions tend to distort market prices and lead to a misallocation of resources. For some critics the use of tax expenditures should be abolished and the Government should give explicit subsidies if it wants to assist particular expenditures[1]; for others the Government should merely calculate and make public the cost of such concessions and the cost of any changes in them.[2] For others the whole concept of "tax expenditures" is suspect if only because any non-taxed item could first have a notional tax rate applied to it, and then be relieved of the tax and so increase Government expenditure (inclusive of tax expenditures).[1]

2.11. While there is merit in this latter viewpoint it is somewhat deceptive to assume, with respect to income, an untaxed "state of nature". If the notional income from owner occupied housing and consumer durables, items in respect of which most interest payments are made, were included in taxable income then the tax deductibility of interest payments would put all income on an equal tax footing. If all savings were tax free then the concessions which were granted in respect of superannuation contributions could not be considered as tax expenditures. None of this is, of course, to suggest that tax expenditures may not be desirable, that they may encourage, at lower

[1]*See* Surrey (1973).
[2]*See* Feldstein (1975).

TABLE 2.5

Tax Reductions and Tax Free Allowances as Share of Gross Income Selected Years, 1950–51 to 1974–75

Tax Year	As a % of Gross Income[1] Reductions[2]	Personal Allowances
1974–75	13·1	32·7
1970–71	12·6	25·0
1965–66	11·8	29·2
1960–61	14·0	29·1
1955–56	13·2	27·5
1950–51	12·8	30·6

[1]i.e. income that comes under the review of the Revenue Commissioners.
[2]Excluding wear and tear allowances.
Source: Revenue Commissioners *Reports.*

cost to the Exchequer relative to explicit subsidies or grants, activities considered worth promoting by the State. We note that the NESC report on Housing Subsidies attempted to calculate the tax subsidy available for mortgage holders as part of the general cost of housing subsidies. Thus the concept has been developed in Ireland although there may be considerable room for discussion over the effectiveness and desirability of these tax expenditures. The point we wish to make is that the existence of tax expenditures can significantly alter the apparent progressivity of the tax system especially if those claiming high levels of tax deductible expenditures are in the upper income brackets.

2.12. Unfortunately, we have no detailed published data on the level of tax deductions claimed by income groups and so the extent to which the income tax base at higher tax rates is eroded cannot be ascertained. We have to make use of aggregate information from the Revenue Commissioners' returns: they use the term "reductions" to cover a wide variety of tax exemptions including mortgage relief;

[1]*See* Pearse (1977).

superannuation contributions and export profits tax relief. We can see from Table 2.5 that, in spite of the massive expansion in PAYE as a proportion of taxable income, the share of reductions in gross income for tax purposes has remained at around 13% over the last 25 years with signs of an increase in recent years. One would suspect that the reduction of the relative size of the tax brackets noted earlier is bound to encourage increased expenditure on tax exempt items. For the top-rate tax payer an increase in mortgage interest paid from £1,000 p.a. to £2,000 p.a. can be effected at a net cost, in terms of disposable income, of only £400 p.a.—the balance representing income tax payments saved. It seems a fairly safe prediction to suggest that, in the absence of increases in the width of bands of taxable income at which increasing tax rates apply, the proportion of gross personal income devoted to tax-exempt expenditure items will increase. If this occurs then it will be increasingly difficult, for a given tax yield, to reduce marginal tax rates and so reduce the tendency to incur high exempt expenditures. For most expenditures incurred are of a long-term nature e.g. mortgage interest and so represent a continuing cost, in terms of revenue foregone, to the Exchequer.

2.13. So far we have concentrated on income taxation as levied through the income tax code. But although income taxes are a significant proportion of total personal income taxes they do not represent the only form of personal income taxation. As Table 2.6 indicates social welfare taxes account for almost a third of total taxes on personal income in spite of the fact that the yield from income tax has been rising relative to incomes in the past decade or more. It is clear that social welfare taxes are a significant component of income taxation in Ireland, although very little attention is normally paid to this form of taxation. This may be because social welfare taxes are not treated in the Budget[1] as taxation and discussion on the annual rate or amount of tax is confined to the debate on social welfare. It may also be because the taxes levied are called "insurance contributions" rather than taxes. It is internationally recognised that such "contributions" are in fact a tax as they are compulsory, non-refundable and

[1]The National Account classification of the Budget which is published at the back of the annual Budget document does include social welfare taxes as income taxation.

do not give rise to benefits directly related to the amounts contributed. An individual who did not wish to be covered for social insurance benefits or old age pensions could not decline to pay the contribution. To that extent it must be regarded as a tax, albeit a partially earmarked tax. By this we mean that the funds raised through social welfare taxation are "earmarked" for expenditure on certain transfer payments to persons who have paid these taxes in the past. It may be argued that although the contributions are compulsory the individual is really participating in an insurance scheme with the constant accrual of entitlement to a pension, sickness benefit, unemployment benefit, etc. But if this were the case one would not expect the scheme to be highly redistributive between those who contribute. For instance, a married man with four children would receive a flat-rate unemployment benefit of £34·25 compared to £13·05 for a single person; yet it is entirely possible that the single person would have paid more "contributions" over his working life than the married man. Similarly, old age pensions are differentiated with respect to dependency even though contributions are not.

TABLE 2.6

Social Welfare Taxes as Share of Industrial Earnings and Personal Income Taxes, Selected Years 1955–1977

	Social Welfare Contributions[1] as a percentage of Industrial Earnings						Social Welfare Taxes as a % of Personal Income Taxes
	Male			Female			
	Total	Employees	Employers	Total	Employees	Employers	
	%	%	%	%	%	%	%
1977	9·8	3·9	5·9	18·6	7·4	11·2	32·6*e*
1976	9·9	4·0	5·9	18·8	7·5	11·3	34·0*e*
1975	8·4	3·5	4·9	15·8	6·6	9·2	35·9
1970	7·0	3·3	3·7	14·6	6·8	7·8	31·0
1965	4·3	2·2	2·1	8·3	4·2	4·1	28·1
1960	2·9	1·4	1·5	5·4	2·7	2·7	24·9
1955	3·0	1·6	1·4	4·1	1·7	2·4	24·3

e = estimated.
[1]Flat-rate contribution only.

2.14. This redistributive aspect of the social insurance code makes the levy on employers and employees difficult to justify as an "insurance contribution". If payment were voluntary (or at least at the option of the *employee*), if individual benefits were related to contributions paid by the individual and if refunds were available in respect of contributions for old age pensions then one could justify the term "insurance". But in such cases the problems for the insurer would be immensely difficult because virtually all those in secure employment and with pension schemes would opt out of the insurance net and those remaining would tend to be in industries with a poor employment record and/or poor pension schemes. In these cases part of the contributions would have to be related to the probability of unemployment which could vary from industry to industry and from firm to firm. In addition, a voluntary scheme would contain a disproportionate number of persons who would seek to exploit the system by claiming unemployment benefit even though they were not looking for employment.

2.15. There is the further point that, if social insurance contributions were voluntary, individuals might well decide that they were poor value for money. It could be argued that the social welfare contribution purchases the individual a cash differential over assistance payments. But the size of the differentials has narrowed sharply in recent years. In 1955, for example, a single man received 1·30 times the total weekly contribution paid in respect of his employment *more* than the single man on assistance for each week of unemployment. By 1977 this had fallen to 0·33 times the total contribution. A similar pattern emerges from Table 2.7 for other family sizes. Thus over time the social insurance tax has "bought" the employee a smaller and smaller differential over assistance payments relative to the size of the contribution. Of course it could be argued that the social welfare contribution also "buys" the lack of a means test. But most payments for assistance or benefit are categorical i.e. one must fall into a defined category such as unemployed, old age, sickness, widowed etc. and with the exception of old age and widows' pensions the value of no means testing may be slight unless it also implies less stringent enforcement of the categorical nature of the payment. It seems fairly safe to suggest that in a voluntary insurance scheme the decline in the differential *vis à vis* assistance would have resulted in a reduction in the willingness to participate in the social welfare insurance system.

TABLE 2.7

Ratio of Differential between Unemployment Benefit and Assistance (Urban Rate) to Social Insurance Contribution for certain family sizes, selected years 1955–1977

	Single	Married	Married +2 Children	Married +4 Children
1977	·33	·43	·56	·72
1976	·31	·41	·52	·67
1975	·39	·51	·64	·84
1970	·54	·74	·92	1·10
1965	·73	·85	1·36	1·86
1960	1·79	1·86	2·39	2·04
1955	1·30	1·74	2·61	2·61

Note: Social Insurance Contribution includes both employer and employee contributions.

2.16. It is therefore best to consider social insurance contributions as an earmarked tax levied on certain employees (and employers) to finance the income maintenance payments received by a significant proportion of the population. As we saw in Table 2.6 these contributions represent a sizeable and growing (at least up to 1977) fraction of average industrial earnings. Further, because of its flat-rate nature (ignoring the pay-related contribution element) the social welfare contribution may impose an extremely heavy tax burden on lower paid workers in general—many of whom are women. The flat-rate contribution clearly has consequences for employment (especially if the tax is borne mainly by the employer) but we will not deal with that aspect here. Our concern is with the personal taxation aspect of the contribution and the impact of such taxation on take-home income from employment. Although the flat-rate contribution imposes a relatively higher tax burden on lower paid employees it is clear that

the average social security tax rate is low relative to most EEC countries. This emerges from Col. (3) of Table 2.8 where social security taxes (including employers' contributions) as a percentage of male industrial earnings are set out. The very high rates applicable in Continental European countries stand out and from Col. (1) and (2) the higher dependence on social welfare taxes as a component of total taxes among the original Six EEC Member countries can be seen.

2.17. The picture of the Irish social security tax system so far presented is one of flat-rate taxes on employment which, while low relative to EEC levels, may impose significantly higher burdens on lower paid employees without especially large increases in income maintenance payments for those covered. However, our concern is more with the interaction of the system as a whole, including benefit levels, with the income tax system and the degree of integration if any, between the two systems. We saw earlier that the real value of personal allowances, which at first seemed to correspond with some minimum income notion, had declined sharply over time. It is interesting to compare social insurance benefits over a comparable period in relation to tax thresholds. This is done in Table 2.9 where it can be seen that by 1977 the annual value of social benefit payments (at October 1977 rates) for unemployed single or married persons exceeded the level of tax-free allowances for these categories. In the case of larger families the benefit level was close to the tax-free allowance level and had increased relatively sharply since 1970. The consequences of this movement are that future inflation-induced adjustments to social benefits will, in the absence of similar adjustments to tax-free allowance levels, lead to wider and wider discrepancies between the two. As short-term social benefits are non-taxable this could mean that persons moving from benefit to employment could suffer a severe drop or obtain only a marginal gain in post-tax income. As we shall see later the implicit tax rate on employment at present is already quite high. It is also difficult to believe that taxpayers in the future would be willing to accept "minimum" income levels for social welfare recipients which were substantially higher than the levels allowable for income tax purposes.

TABLE 2.8

Relative Importance of Personal Taxes and Social Welfare Taxes in Total Tax Receipts, EEC Countries 1974

	(1) Personal Income Tax and Social Welfare Taxes as % of Total Tax Revenue	(2) Social Welfare Taxes as a % of Total Personal Income Taxes and Social Welfare Taxes	(3) Social Security Tax as % of Average Male Industrial Earnings
Belgium	60·6	51·8	50
Denmark	54·0	2·5	n.a.
Germany	61·3	55·0	28
France	48·6	79·8	43
Ireland	38·3	30·5	10
Italy	57·0	73·2	56
Luxembourg	54·8	51·8	n.a.
Netherlands	66·7	59·3	47
United Kingdom	49·9	37·1	14

Source: (1) and (2) from Annex IV of "The Impact of Rising Prices on Taxation and Social Security Contributions in the European Community" Commission of the European Communities *Economic and Financial Series* No. 12 (1976). (3) from *Revenue Statistics of OECD Member Countries 1965–74* OECD (1976) Appendix 2.

2.18. Apart from the relationship between tax-free allowances and social benefit levels the treatment of dependants can be a major source of problems generated by the interaction of the welfare code and the tax system. In general, private employers do not pay employees additional wages in respect of a dependent wife or children. Wage levels are determined independently of family circumstances and it is left to the tax system, if possible, to make the necessary adjustments. But the present nature of the tax system can only adjust incomes downward. Thus single persons can be taxed more than married persons with the same aggregate income; but large families with low incomes cannot be positively aided through the tax system. At best they can be relieved of paying income tax (although not social welfare taxes). On

the other hand, the social benefit system does make increased payments in respect of dependants so that for large families with low incomes the gap between benefit income and employment income may be quite small. For a taxpayer the value of a child (in terms of tax saved) may be significantly lower than the value of the same child in terms of social benefit available. In Table 2.10, we have set out the ratio of child benefit under social insurance to the value of a tax-free child allowance evaluated at the standard tax rate. It is clear that the relative value of the insurance benefit has increased rapidly in recent years so that in 1977 the value of benefit was nearly 2½ times the tax saving implicit in the tax-free allowance structure. It is this type of discrepancy which tends to lead to the emergence of "poverty traps" where the circumstances for low income families are hardly improved by finding employment.

TABLE 2.9

Ratio of Unemployment Benefit to Income Tax Threshold

	Single	Married Couple	Married +2 Children	Married +4 Children
1977[1]	102·0	101·9	95·6	89·0
1970	70·5	70·4	52·0	42·2
1965	35·5	35·9	30·4	25·6
1960	25·0	22·3	18·8	13·6
1955	31·2	29·3	19·5	13·9

[1]October 1977 benefit rates used.

TABLE 2.10

Ratio of Child Benefit under Social Insurance to Cash Value of Tax Allowance at Standard Tax Rate

1977	2·32
1976	1·744
1975	1·644
1970	0·891 (0·990)[1]
1965	0·89
1960	0·55
1955	0·49

[1]Children under 11.

Note: Ratios are calculated on benefit rate for first or second child.

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2.19. Of course the position of larger income families might have been improved if during the period under review the universal child allowance had increased rapidly in relation to earnings. In fact this has not been the case as can be seen from Table 2.11 where children's allowances as a percentage of industrial earnings is shown. The position for larger families has deteriorated although the position with respect to one child families has improved (relative to pre-1973) and for 2 children families has remained about the same (again relative to the pre-1973 position). But there is no evidence that the erosion in the real value of the child tax allowance and the relative increase in the value of child social benefit levels have been offset, for the worker with a large family, by more generous universal child allowances.

TABLE 2.11

Children's Allowances[1] as % of Average Male Industrial Earnings.

	Number of Children			
	1	2	3	4
	%	%	%	%
1977	0·7	2·0	3·6	5·1
1976	0·8	2·1	3·6	5·1
1973	1·3	3·1	5·5	7·3
1970	·05	1·9	4·1	6·3
1965	·1	2·1	4·4	6·6
1960	—	1·8	4·4	7·0
1955	—	2·3	4·3	6·7

[1]Allowance for dependent children payable at Post Offices.

2.20. Our concern with the lack of integration of the income tax and social welfare code has been due to the possibility that undesirable anomalies can occur not least of which is the effect of high effective tax rates on the return to employment for low income families. Here we are using the term "effective tax rate" in a different way to that normally understood. If an individual works for £X gross pay and £Z after tax and social welfare but, as a result of working, is only £Z−Y better off than before working we say that the effective tax rate is (X−Z−Y)/X, i.e. the proportion of gross pay which he gets as an increase on his pre-employment income is only (Z−Y)/X. The value

of Z will depend on the level of social insurance contributions and on the provisions of the income tax code while the value of Y will depend on the level of social benefits. Thus a married man with 2 children who obtains employment at the 1977 average industrial wage of £73 per week would have £58·49 left after income tax and social insurance contributions. On the other hand, had he remained on flat rate social welfare benefit he would have obtained £29·44. By our definition the effective marginal tax rate (or tax and withdrawal of benefit rate) is 60·2%, i.e. £58·49—£29·44 is the net gain from employment and this is 38·9% of the gross pay of £73.

2.21. In Table 2.12 we have set out the rates for a number of family sizes and for employment at various percentages of average industrial earnings for a number of years. The upward trend in the effective marginal tax rate is clear as is the fact that in 1977 a married man with 4 dependents would lose income if he took employment at pay equal to half the average industrial earnings level. It can be seen that for many income levels the effective tax rate exceeds the highest marginal tax rate in the income tax code. Thus high "marginal tax rates" are not confined to those at upper income levels. Part of the problem is due to the treatment of families in the income tax code, part is due to the fact that the present income tax code can only be adapted to relieve the working poor of tax and cannot transfer income to them and another part is due to the flat rate social insurance contribution and to the non-taxable nature of short-term social insurance benefits. All these are aspects of the lack of integration of the income tax and social welfare systems. If we had included the role of pay-related benefits the anomalies, particularly with respect to non-taxability of benefit, might have been more glaring. And, in our calculations, we did not deal with the possibility of tax refunds which can arise because of the cumulative nature of the PAYE tax code (i.e. tax-free allowances etc. are calculated on a weekly (monthly) basis and the weekly (monthly) tax liability calculated as if the weekly amount was payable for each of the 52 weeks so when unemployment occurs some weeks are calculated at zero wage levels and tax refunds occur).[1]

[1]For a wider discussion of the cumulative and non-cumulative aspects of income taxation see Barr, James and Prest (1977).

TABLE 2.12

Proportion of Gross Income withdrawn through Income and Social Welfare Taxes and loss of Benefits, selected years 1955–1977.

	Income as a % of Average Male Industrial Earnings											
	50%	75%	100%	50%	75%	100%	50%	75%	100%	50%	75%	100%
	Single Person			Married Couple			Married with 2 Children			Married with 4 Children		
1977[1]	·59	·50	·46	·76	·60	·54	·91	·69	·60	1·04	·76	·64
1970	·55	·45	·40	·72	·57	·58	·86	·55	·46	·97	·64	·48
1965	·38	·33	·31	·57	·38	·35	·76	·50	·38	·87	·58	·44
1960	·33	·27	·26	·49	·33	·24	·65	·44	·33	·65	·44	·33
1955	·34	·32	·27	·50	·33	·25	·68	·45	·34	·68	·45	·34

[1]October 1977 benefit rates used. Average earnings of £73 p.w. assumed.

2.22. In this Chapter we have seen that tax-free allowances have fallen significantly in real terms over time and cannot be considered as a minimum income concept but must be viewed as an integral part of the progressivity structure of the tax code. We saw also that social welfare benefit levels are now virtually identical to tax-free allowances which suggests that the scope for further real falls in the latter (assuming constant real social welfare levels) is likely to be reduced unless extensive and visible anomalies are permitted. We also saw that the Irish income tax structure was relatively compressed with a fairly small range between the low and high marginal tax rates. This may be due in part to the extent to which personal tax-free allowances and "tax expenditures" create a wide gap between total income and taxable income. The consequences are that increments to income are taxed at high rates relative to the average tax rate that applied to the income prior to the increase. We saw that, for lower paid workers, social welfare taxation imposed a significant average tax burden and that the "value" of such social welfare tax contributions had declined relative to assistance payments in recent years. We saw also that allowances for child dependents in the social welfare code had risen relative to the value of tax-free allowances

while universal cash grants for children had declined relative to earnings. The existence of dependency allowances in the welfare code but not in the pay structure can give rise to "poverty traps" and we examined the extent to which earnings were reduced by a withdrawal of benefit and by taxes for low income families. In general we found that the interaction of the social welfare code, the personal income tax code and social insurance taxes led to relatively high effective tax rates on all social welfare beneficiaries but particularly on the incomes from employment of larger families.

Chapter 3

CHARACTERISTICS OF ALTERNATIVE TAX AND TRANSFER SYSTEMS

3.1. The issues raised in Chapter 2 are not unique to the Irish tax and social security codes. Indeed they are shared to a greater or lesser extent by virtually all developed economies.[1] And in recent years some countries have adopted policies (or proposed the adoption of policies) designed to overcome some or all of the difficulties outlined earlier.[2] Thus it is possible for us, in the next few chapters, to consider modifications to the tax/transfer system which have been proposed or adopted elsewhere. Of course few countries have identical tax and transfer systems and so we will have to adjust the various schemes to suit Irish circumstances and characteristics. But before examining any detailed proposals it would seem best to examine some of the broad principles behind the particular forms the proposed schemes take.

3.2. It is clear that one could, through a piecemeal approach, remedy one or more of the problems with the tax/transfer system raised earlier. Thus, for example, the problem of the erosion of the tax base through deductions (and the consequent steepening of the nominal progressivity of the tax code) might be handled by an income tax reform which abolished, or limited, the availability of tax deductions

[1]See, for example, Palmer and Minarik (1976), The Institute for Economic Affairs readings on the *State of Taxation* (1977), the *OECD* discussion of *Negative Income Tax* (1974), the UK Green Paper on *Proposals for a Tax Credit System* (1972) and the examination by Atkinson (1973) and the Institute for Fiscal Studies.

[2]Collins (1977) and Ben-Porath and Bruno (1977) give interesting analyses of recent Australian and Israeli tax changes respectively. The OECD (1977) examination of the tax and transfer treatment of member countries also gives details of recent changes in tax regimes.

while at the same time reduced tax rates. Similarly, the regressive nature of the existing flat rate contributions to social insurance financing might be replaced by a pay-related contribution system.[1] By making short-term insurance benefits taxable many of the problems concerning the high effective marginal tax rate on low paid employment might be reduced—although new difficulties, especially in administartion, might be introduced. But such an item-by-item approach to reform tends to ignore the central point which is that tax and transfer programmes must be seen as components of a single system even if the administration of the tax laws and the transfer programmes are handled by different agencies. Also, by failing to adopt an integrated approach, it is possible to introduce new anomalies while attempting to solve existing ones. For example, the introduction of pay-related social welfare contributions could, in the absence of any changes in income taxation, increase the marginal tax rates faced by low and middle income earners even though their *average* tax rate (including social insurance) might have fallen.

3.3. This is not to suggest that the alternatives set out in this Chapter comprehensively and simultaneously deal with all the existing problems raised by our tax and transfer system. However, there are substantial common elements running through the three systems proposed which range from relatively minor modifications of the existing tax code to more radical changes in the way we organise our taxes and income transfers. The most notable common element is the use of tax credits in place of existing income tax allowances. The concept of tax credits is fundamental to a whole series of proposals concerning the integration of tax and transfer systems collectively known as Negative Income Tax proposals. At their simplest, tax credits merely replace existing deductions from taxable income (or "tax-free allowances") with credits of a fixed cost value. Thus an Irish married taxpayer might be offered a tax credit of £325 instead of a tax-free allowance of £1,100 which could be worth[2] as little as £250 to an

[1]Such a move was recommended in the Government Green Paper on Economic and Social Development 1976–80.

[2]As the 20% tax rate applies only to the first £500 of taxable income the minimum 'full value' of a tax free allowance is £250. However, for those with incomes below £1,100 the value of the tax-free allowance is obviously less.

individual on £1,100 p.a. and as much as £660 to someone with an income of £8,100 p.a. If the tax credit is non-refundable (i.e. any married couple with tax liabilities less than £325 in our example would *not* receive the cash difference between their liabilities and £325 from the State) then the main advantage of a tax credit scheme is to redistribute income from high income tax payers in the tax net to low income tax payers. If it was not intended that such a redistribution should take place an adjustment of tax rates, especially upper rates, could accompany the introduction of tax credits. When tax credits are refundable so that low income earners who have unused credits receive a cash grant from the State equal to the unused amount one can see how such a system might be part of an integrated approach to income maintenance.

3.4. Another feature common to the proposals outlined later is the incorporation of a proportionate social security tax into the general treatment of income taxation. To some extent this is unexceptional in that a move towards proportionate social welfare contributions has been proposed recently. However, certain general features of the proposals included here are worth discussing in advance of any consideration of the details of the schemes. Social security taxes, when proportional, are usually levied on gross earnings from employment i.e. before making any allowances for family circumstances, expenses, superannuation and mortgage interest payments etc. Therefore, for those in employment the income base on which social welfare taxes are levied differs from that on which general income taxes are levied.

Also, most countries which rely on social security taxes have an upper limit above which no taxes are assessed.[1] Thus for the majority of employees social security taxes are proportional but the system, as a whole, is slightly regressive.[2] In our treatment of direct taxes in the following Chapters the income base is the same for income and social security taxes—mainly because deductions from income allowable for tax purposes are evaluated at a fixed rate (or are not

[1]Among OECD member countries, Italy, Spain, Portugal, Denmark, Finland and Switzerland have no upper limit on social security taxes.

[2]Regressive is defined here as a declining ratio of tax payments to income as income increases.

allowable at all). Also we impose no upper limit on social security taxation mainly because the levy has been incorporated into the general income tax rate structure proposed.[1]

3.5. A third feature, common to all our proposals, is the extension of the tax base (or the reduction in the erosion of the base) by the limitation or abolition of many or all "tax expenditures" or permitted deductions from taxable income. We mentioned, in Chapter 2, some of the issues involved in this treatment of certain deductible expenditures. Our objective here was to attempt to have a single, easily understood, base for income and social security taxation which would also permit a general lowering of normal tax rates (though not necessarily of effective tax rates which at present depend on the share of deductible expenditure in gross income) for most income levels. This should help to bring marginal tax rates closer in line with average tax rates and so reduce the disincentive effects of income tax rates. Also the limitation (or elimination) of "tax expenditures" should help reduce the distortion in expenditure patterns which such tax treatment tends to encourage. Although we have no published information on the distribution of deductible expenditure by income groups for taxpayers studies from other countries[2] suggest that the main beneficiaries of these tax concessions are in the higher income groups.[3]

3.6. All our proposals are designed, at least *a priori*, to be administratively simple and indeed to lead to savings on administrative

[1]There are some reasons, which we discuss later, why one might want to identify social security tax separately. Not least of these is the argument that higher tax rates can more easily be levied if they are seen to be used for social security transfers. However, this raises the whole question of the 'earmarking' of revenues for particular expenditure purposes and we cannot deal with this issue here. While there may be no particular objections to identifying a tax as a social security tax there may be good reasons for declining to devote all or part of the proceeds to particular social security expenditures.

[2]See Collins, *op. cit.* and Pechman and Okner (1974).

[3]For a given expenditure of £100 on interest payments the top income earner saves £60 in tax while the lowest income tax payer may save only £20. Further, the higher income tax payer is more likely to have interest payments and, for similar age and family structure, is more likely to devote a higher proportion of his income to such tax-deductible items.

costs relative to the present system. However, there are learning costs associated with any new policy and so the savings, at least for some of the proposals, may be less obvious. Further, the present system of income and social welfare taxation imposes considerable, though unmeasured, costs on employers who are responsible for implementing the PAYE tax system and the social welfare stamp scheme. Proposals which appear to reduce administration costs for employers (and other tax payers) while leaving the cost of collection of revenue to the Exchequer unchanged ought to be as acceptable as proposals which produced equivalent administrative savings for the Exchequer alone. Unfortunately, a cost unmeasured is too often a cost unconsidered. The schemes we have suggested below are designed to minimise the cost of administering a tax system, a transfer system or both. However, it would be beyond the scope of this study to examine in detail the manner in which the schemes would be administered; we shall have to be content to leave it to the reader to decide whether the alternatives proposed represent a simplification of the present complex system of income taxation and social insurance.

3.7. Most tax reform proposals, particularly those which involve a fairly major recasting of the tax system, have to face the problem that some individuals may lose out in the process. If the reforms are evaluated about a constant revenue yield (so that in the post-reform period the Exchequer take is the same as in the pre-reform era[1]) then there must also be those who gain. Inevitably, the gainers do not compensate the losers and so resistance to reform develops. This is especially likely where those who lose can be more readily identified than those who gain. The political realities of resistance to tax reform are such that minor modifications to existing tax structures are almost invariably preferred. Thus an increase in personal allowances of, say, 10% will make everyone in the tax net better off[2] relative to the present position and so opposition is likely to be confined to the scale of the increases in allowances rather than the principle. On the other hand, it may be possible, for a lesser sum, to implement a major reform which would, however, lead to increased taxes for some groups. But this option is less likely to be pursued because of the opposition raised by the losing group; indeed the more numerous (or more influential) the losing group the lower the likelihood of reform. The political realities of tax reform are such that the constraint that proposed reforms should involve no loss in revenue to the Exchequer is particularly severe. We have attempted to operate within this broad constraint, however, because to do otherwise would be to raise the possibility of a host of tax reductions masquerading as "reforms". At the same time, we have attempted to ensure that, as far as possible, there are no very large losers from the systems proposed. Inevitably there will be some losers and some gainers and those who examine the proposals will be able to work out the net gain or loss to themselves. Unless a surprising degree of hitherto unsuspected altruism beats in the breast of the taxpayer the net position may determine the response to the changes proposed. In cases where the constraint of no net cost of reforms to the Exchequer could involve sizeable losses to certain groups we have tolerated a certain amount of revenue loss; this is particularly the case when the reforms contain other features which are absent from existing tax/transfer schemes and the introduction of which would involve increased public expenditure.

[1]Ignoring, of course, any effects induced by the change in tax regimes.

[2]Relative to the period immediately preceding the tax change. A 10% increase in allowances would not, in the face of a 15% rise in prices, leave individuals better off relative to the position obtaining at the begining of the previous tax year. If the tax changes *due to inflation* were taken into account it is possible that a policy bias towards incremental adjustments in the existing tax code would not exist.

Chapter 4

A NON-REFUNDABLE TAX CREDIT SCHEME

4.1. In this Chapter we outline modifications to the existing income tax code which would meet some of the issues raised in Chapter 2. The proposals here represent fairly minor modifications to the present code and are far less radical than those contained in later chapters. The main features of the proposals are the substitution of tax credits for tax-free allowances; the abolition of employee social welfare contributions and their replacement by a general proportional income tax; the restriction of tax expenditures on mortgage interest, superannuation etc., to a tax credit evaluated at the lowest tax rate; and the reduction in the higher tax rates.

4.2. The important details of the scheme are as follows:

Tax Credits

(i) To a certain extent the level of credits chosen are arbitrary in that they were designed to ensure that few persons in the tax net were made worse off than under the present system.[1] Since the introduction of credits would be accompanied by changes in the financing of social insurance and the structure of tax rates the credit levels chosen are not simple translations of existing tax-free allowances into cash value terms.

The following structure of tax credits is proposed

	£
Single Persons	50
Married Couple	170
Married Couple + 1 dependent child	240
Married Couple + 2 dependent children	340
Each additional dependent child	100

[1]As we noted in Chapter 2 the existing tax allowances are arbitrary and appear unrelated to estimated minimum income levels.

It will be noted that the credit for a single person is less than for a dependent child. This is because the later proposals in respect of tax rates and social insurance would yield substantial after tax gains to single income earners whereas dependent children would not gain from these tax adjustments.

Expenditure on Interest, Superannuation etc.

(ii) the existing full relief from income taxation of morgage and other personal debt interest (up to £2,000 p.a.), life assurance premia, VHI and superannuation contributions etc. would cease and be replaced by a tax credit equal to 20% of the expenditure so incurred. Thus relief from income tax on these expenditures would be confined to the lowest tax rate and high income individuals would not be able to avoid income taxation by increasing their tax exempt expenditure.

Social Welfare Taxation

(iii) The existing flat rate contribution to the social insurance stamp would be abolished. In its place there would be a general 5% tax on all incomes, regardless of how derived, without any upper ceiling. The tax would apply to the incomes of those covered at present by full social insurance and to the incomes of those at present outside the full social insurance net (including the self-employed and certain public servants). It is not the intention of the scheme that the revenue raised should be "earmarked" for social welfare payments. Indeed the resources raised would exceed the amounts at present derived from social insurance payments by employees and also the amounts spent on social *benefits*. The funds raised would be considered as part of general government revenue although no particular disadvantage would accrue to allocating them to social welfare transfers because the revenue raised would be far less than is currently spent on all such transfers.[1]

[1]Although it should not directly affect personal taxation the conversion of the flat-rate employers stamp to a pay-related basis might reasonably accompany the proposals here. Such a conversion would not raise any extra revenue although it would redistribute the tax burden among employers and the total revenue for 'social security' taxes would be far less than total expenditure on social transfers.

The extension of the "social security tax" to the self-employed is simply a recognition that social insurance is a tax and as such ought properly to be levied on the general tax-paying population.

New Tax Rates

(iv) To a large extent the extension of "social security" taxation to the self-employed (and certain public servants) would be offset by the proposed changes in the structure of tax rates which would be as follows

Gross Income (£)	Tax Rate (%)
0 2,500	20
next 2,500	25
next 2,000	30
next 2,000	35
next 2,000	40
Balance	45

When combined with the "social security" tax the marginal tax rates vary from 25% to 50%. With the conversion of tax-free allowances and the tax deductibility of certain expenditures into credits the base of both taxes is virtually identical. Therefore there is no particular need to identify the social security tax separately in the scheme proposed here. However, we have done so in order to illustrate the link between the existing structure and the tax credit proposals. But the separate identification of a social security tax does not imply that payment of this tax determines eligibility for non-means tested social insurance benefits in the same way in which payment of insurance stamps determines eligibility. The existing scheme of social insurance benefits would continue with eligibility being determined by employment experience.[1] Of course all taxpayers, both employed and self employed, would continue to be eligible for social assistance and their "social security tax" could be seen as a contribution towards the costs of such transfers.

[1]Given that employers would still be paying a contribution in respect of each employee there should be no difficulty in determining eligibility under conditions similar to those in force.

4.3. Under the scheme proposed above all taxpayers with the same gross incomes would have the same gross tax liabilities. Their net liabilities would be determined by the particular family circumstances of the taxpayer and the level of expenditures qualifying for tax credit relief at 20%. Thus employees under PAYE would be issued with a certificate setting out the weekly or monthly value of their tax credits and this would be deducted from their gross liabilities (calculated from their gross earnings) in order to arrive at the level of tax payable.

4.4. To illustrate the tax credit scheme and compare it with the present tax structure let us examine the tax position of a married man with 2 children earning £70 per week with expenditure on tax deductible items of £200.

	1977–78 Tax Code	Tax Credit Scheme
	£	£
Earnings	3,640	3,640
Deductible Expenditure	200	—
Tax-Free Allowances	1,580	—
Taxable Income	1,860	3,640
Tax Assessed	476	785
Social Security	129	182
(Tax Credit)	—	(380)
TOTAL TAX PAID	605	587
TAKE HOME PAY	3,035	3,053

In this example there is a small net gain to the taxpayer with the higher "social security tax" being offset by the reduction in income tax. Persons with lower incomes would gain more because of the proportional social security levy. In Table 4.1 we have set out the effect on after tax income, relative to the 1977/78 tax and social insurance code, of the proposed tax credit scheme for a number of income groups and family sizes. It will be noted that the major gains are, in general, made by individuals on low incomes and by larger families. However, the percentage increases in take-home pay are not evenly distributed between income groups. In general, low income earners gain mainly because of the abolition of flat-rate social insurance. High income earners gain because of the reduction in the top marginal tax rate to 50%. In the middle the gains are more modest due to the constraint that the scheme should involve no net loss to the Exchequer.

4.5. It may appear strange that Table 4.1 suggests that all income groups and family sizes would benefit from the proposed changes in the tax and social insurance code. But this is not the case due to the expansion of the social security tax net which would not include the self-employed and certain public servants. The gains from moving from the present income tax and full social insurance contributions to a

TABLE 4.1

Effect on after-tax income of non-refundable tax credit scheme for various income levels

Gross Income £ p. a.	Gross Tax Liability[1] £ p. a.	Change in after-tax income[2] due to proposed tax credit scheme: Single Person %	Married Couple[3] %	Married[3] with 2 children %	Married[3] with 4 children %
1000	250	2·1	8·1	17·5	17·5
1500	375	0·7	1·9	8·5	11·1
2000	500	0·5	1·2	4·2	8·1
2500	625	2·2	1·0	3·2	6·7
3000	775	3·0	1·5	1·8	4·7
3500	925	2·8	1·6	1·4	2·6
4000	1075	3·3	2·1	2·1	2·9
7000	2075	7·5	5·3	4·1	3·6
9000	2875	12·3	9·4	7·0	5·4

[1]Tax liability before personal tax credit (or credit for allowable expenses).
[2]Income after tax and social insurance contributions (excluding pay related contribution).
[3]Wife not working.

tax-credit and proportional social security levy would have to be offset by up to £105·6 p.a. in the case of certain public servants and up to £149·2 p.a. for the self-employed. In these cases the tax credit scheme could result in a fall in take-home pay just as the expansion of the social welfare net in 1974 reduced the take-home pay of those who had been outside it. A second, and perhaps more important, source of loss to taxpayers lies in the restriction of tax deductibility for certain interest and superannuation payments. This is likely to reduce, or offset, the after-tax gains for upper income groups. In Table 4.2 we have set out certain stylised combinations of tax deductions, income levels and family sizes. The deduction levels have no objective validity but are, broadly, comparable with the levels assumed in NESC Report No. 11 on Income Distribution. That report, however, tended to confine its attention to larger families at a particular point in the life cycle of earnings and mortgage obligations. The actual distribution of deductible expenses by income group is not published by the Revenue Commissioners and so the data in Table 4.2 must be considered illustrative. It is clear from a comparison of Tables 4.1 and 4.2 that the restriction of tax deductible expenses tends to offset the apparent gains to higher income groups.[3] In

TABLE 4.2

Impact of deductions on after-tax income under limited Tax credit scheme

	Gross Income Levels (£ p. a.) 3400	5000	8500	13000
Assumed Level of Deductions[1]	180	600	1150	1500
% change in after tax[2] income for:	%	%	%	%
Single Persons	1·5	1·5	2·5	2·9
Married Couple	0·3	0·6	2·7	1·2
Married Couple + 2 children	0·3	0·6	−0·1	−0·2
Married Couple + 4 Children	2·5	1·4	−0·3	−1·1

[1]Includes mortgage and consumer debt interest, superannuation, VHI contributions etc. Based, broadly, on ratio of deductions to income outlined in NESC Report No. 11.
[2]Including social insurance contributions.

[3]For example, if our family in Table 4.4 had deductible expenses of over £320 they would lose rather than gain from a reform on the lines suggested.

E

Appendix Table A.1 we have set out the cash values of income and tax levels under the existing and the proposed code. This data simply amplifies the information in earlier tables.

4.6. The non-refundable tax credit scheme outlined above has concentrated on the tax side of the tax and transfer system. We have not discussed any alterations in the nature and structure of social welfare transfers nor have we attempted to integrate the transfer and tax systems. Much of the benefit to low income taxpayers comes from the introduction of proportional social insurance payments; middle and upper income taxpayers benefit from the moderation in the steepness of the rate schedule; and the erosion of the tax base at upper income levels is halted by the treatment of deductible expenditures. None of the changes proposed here would involve a radical change in the administration and collection of income and social welfare taxation. No changes in the administration of the social welfare systems of transfers would be involved. But the proposals here represent a first, and essential, step towards a more comprehensive and integrated approach to tax/transfer systems. As we shall see most, if not all, of the elements of the non-refundable tax credit scheme can be modified to produce the more comprehensive schemes discussed below. These more comprehensive schemes will be designed to help low income families outside the tax net (other than via the introduction of income related social welfare contributions) and to reduce the effective tax rate on the return to employment for low income families.

Chapter 5

A REFUNDABLE TAX CREDIT SCHEME

5.1. In our proposals in Chapter 4 we dealt exclusively with the income tax code and the tax element of the social welfare code. But we made no effort to link the two systems together in an explicit fashion. Thus while tax credits and proportional social welfare contributions help reduce the extent to which low income "poverty traps" can occur they represent only a partial solution. In this Chapter we consider a more radical, and more integrated, approach to the problem of the need for tax and transfer integration. The main features of the proposals here, which build on those set out in Chapter 4, are that the tax credit is increased and becomes refundable (i.e. for those with tax liabilities less than their allowable tax credit a cash refund is made equal to the difference); short-term social insurance benefits would become taxable although no tax would be paid by persons in receipt of benefit alone; tax rates would, however, be increased to finance the refundable credits and their higher level.

5.2. There are problems, however, about making tax credits refundable given the existing scope of the income tax system. At present most incomes from farming are not liable to income taxation; they cannot, however, be assumed zero for the purposes of tax/credits/transfers. If that were the case then all farm households with rateable valuations under £75 would be in receipt of full cash transfers because their income, for tax purposes, was zero. Similarly only social insurance benefits, which require a contribution condition, and universal child allowances are payable without a means test and the extension of more general cash transfers would represent a major alteration in the present system of social benefits and assistance. In addition short-term social transfers are not taxable and so those in receipt of such payments would be major beneficiaries of a conversion of tax credits into refundable cash grants. In order to minimize the alterations required in the present system of social transfers and income taxation it will be necessary to confine the refundable cash element of the tax credit system to those in employment.[1]

Revised Tax Credits

5.3. In order to avoid the situations where unemployment benefit would be taxed if it were the only source of income, we raised the level of tax credits as follows:

	£
Single Persons	204·00
Married Couple	336·50
Addition for 1st or 2nd dependent child	195·00
Each additional child	161·20

Increase in Tax Rates

5.4. The rationale for the increase in tax credits can only be understood when it is realised that to finance the revised scheme it would be necessary to raise the income tax rate by 5 percentage points at each of the bands set out in Chapter 4. Thus total tax levied at each tax band (including the "social security" tax) would be:

£ gross income	Tax Rate (including social security) %
0—2500	30
next—2500	35
next—2000	40
next—2000	45
next—2000	50
Balance	55

Even with the increased tax rate we shall see that the revisions would involve the Exchequer in a net loss of revenue.

[1]It ought not be difficult to delineate the applicable population since employment status has to be determined, in a legal sense, for much of existing labour legislation. As a working definition those at present covered by PAYE taxation would do.

Tax on Social Security

5.5. The tax payable on existing weekly social insurance benefits would be:

	£
Single Persons	3·92
Married Couple	6·47

which would be exactly offset by the suggested tax credits. A single person would be liable for £3·92 on unemployment social benefit of £13·05; this liability would be exactly offset by the weekly credit of £3·92. Similarly for a married couple. A married couple with 2 dependants would receive benefits of £21·55, the tax liability on which would be offset by the married couple's credit of £6·47, plus non-taxable cash transfers (refunds of unused tax credits) of £3·75 p.w. in respect of each child. Thus, single or married social welfare beneficiaries would be no worse off under this scheme than under the present system. The child tax-credits (which are payable as cash grants for those with insufficient income to pay tax) would replace existing child allowances for those unemployed and on benefit. For the higher income taxpayers the child credits would be used to reduce the amount payable in income tax. The credit levels set out are determined by 1977 (Oct.) levels of social welfare benefits. Universal child allowances would continue to be payable through the post office.

Treatment of Tax Expenditures

5.6. Because we have raised the tax rates by 5 percentage points we shall have to raise the tax rate at which tax expenditures (i.e. expenditure on interest payments, superannuation etc.) are evaluated for tax credit purposes. Thus a person with £500 in interest and superannuation payments would have a tax credit of £125 in respect of such expenditure.

5.7. The refundable tax credit scheme is best explained by examining the tax treatment of a low income family under the existing tax/transfer regime and under the proposed credit system. We will assume a family with four children and the husband alone at work. (We also set out the tax treatment under the refundable tax credit scheme of our 2 child family earning £3,640 described earlier in Chapter 4.):

	Existing System	Refundable Credit	
	£	£	£
Earnings	2,500	2,500	3,640
Deductions/Expenses	50	—	—
Tax-free Allowances	2,060	—	—
TAXABLE INCOME	390	2,500	3,640
Tax Payable	78·0	750	1,149·0
Social Insurance	149·2		
Less Tax Credits	—	(750)	776·5
TOTAL TAX PAID	227·2	—	372·5
plus unused Tax Credits	—	311·4	—
TAKE HOME PAY	2,272·8	2,811·4	3,267·50

We have ignored pay-related contributions in our calculations of social insurance taxes. In the existing system a married man with 4 children on £2,500 p.a. with £50 deductible expenses would pay income and social security taxes of £227·2 or 9·1% of his income. In the tax credit scheme his gross tax liability would be £750 of which £625 would be income tax and £125 on social security levy. But from Paragraph 5.4 we can see that this family is entitled to a tax credit of £1,061·4 (including £12·50 for allowable expenses) whereas gross income and social security liability is only £750.[1] Therefore the family is entitled to a refund, or cash grant, of £311·4. On the other hand, our £70 p.w. family pay a net tax contribution of £372·5 since the gross tax of £1,149 more than offsets the refundable credits of £776·5 (including £50 for allowable expenses). Even in this case, however, the family is better off than under the present code or under the non-refundable tax credit scheme as may be seen from Chapter 4.

[1]We could, if we wished, treat the tax credits as applicable only to income tax liabilities and not to social security taxes. The refundable nature of the credits, makes such a treatment of no consequence to the take home pay of the tax-payer but it may be considered preferable to maintain a separate identification of social security tax payments.

5.8. This scheme would cost more than the scheme outlined in Chapter 4. The additional cost was calculated[1] as follows:

	£ million
(i) Single Person Grant/Credit	62
(ii) Married Couple Grant/Credit	58
(iii) Child Grant/Credit	72
(iv) Increase in rate for evaluating Tax Expenditures	10
Total	202

On the basis of 1977 income levels the increase in tax rates by 5 percentage points, as suggested in paragraph 5.4, would raise £120 million in revenue. Thus tax rates would vary from 30% (including social security levy) to 55%. Now an additional 3 percentage points would raise virtually all the resources needed to fund the refundable tax credit scheme but this would tend to raise the marginal tax rates faced by a significant proportion of middle income earners (i.e. those earning from £2,500 to £5,000 p.a.) and, as Table 5.1 indicates would almost certainly mean a reduction in take home pay for certain middle income groups especially single and married persons with no dependants. Accordingly, we felt the constraint that no large body of tax-payers should be substantially worse off after a tax change more pressing than the constraint that no loss of revenue to the Exchequer should be involved. This indicates that any major reform of the tax system is likely to cost money or else is likely to be resisted by powerful interest groups.[2] However, as we shall discuss below, there are areas where the introduction of the new scheme would save revenue and so reduce the net cost.

[1]Based on an estimated 404,000 single persons eligible (compared to a 1974/75 total of under 392,000) at an *additional* cost (over the non-refundable scheme) of £153·84 per taxpayer; an estimated 350,000 married couples eligible (compared to a 1974/75 total of 313,000) at an additional cost of £166·44 per couple; and an estimated 800,000 children eligible (against 600,000 in 1974/75) at an additional cost ranging from £125 to £61·2 per child. The distribution of the children by family size was based on the pattern of existing universal children's allowances paid by the State.

[2]The UK tax credit proposals of 1972 involved a loss in tax revenue of about £1,300 million.

5.9 In Table 5.1 we have compared the after-tax income levels under the refundable credit scheme and the existing tax code. It is clear that the refundable credit scheme gives major gains in take home pay to those on lower incomes and especially those with larger families. Again the caveats expressed about comparisons between the non-refundable credit scheme and the existing code apply here. If account were taken of mortgage interest deductions etc. the gains at middle and upper income levels might be reduced or entirely offset. By comparing Table 5.1 with Table 4.2 we can see that the refundable credit scheme tends to be more redistributive with greater gains in take-home pay relative to the present code for low income groups of all family sizes and reduced gains for upper income groups. We have also set out in Appendix A2 the data on which Table 5.1 was based and comparisons with Table A1 can be readily made.

5.10. The refundable aspect of the scheme would be confined to those in PAYE employment and those who qualify under present regulations for social insurance benefits. Self-employed taxpayers would, of course, benefit from the higher level of tax credit available and would have to pay the higher tax rates, but if tax liabilities were less than available tax credits no refund would be paid. Because the scheme is confined to employees its administration should not prove any more costly than the present PAYE and social welfare structure. Employers would calculate the net tax/cash grant position for each employee in the same manner as they calculate PAYE at present. In the first instance employers would pay the cash grants to eligible employees and this could be reclaimed from the Exchequer. In general most employers would have a mix of tax paying employees and cash-grant recipients. They would remit only the net amount due from their work-force (or reclaim the net amount paid). Special arrangements might be made for employers who have cash flow difficulties caused by a very high proportion of the work-force being eligible for refundable credits.

5.11. Because the scheme is confined to employees it would be possible to adopt a non-cumulative system of credits and transfers.

TABLE 5.1

Effect on after-tax income of refundable tax credit scheme for various income levels

Gross Income £ p. a.	Gross Tax Liability £ p. a.	Single Person %	Married Couple %	Married +2 Children %	Married + 4 Children %
1000	300	15·3	21·8	67·7	105·6
1500	450	7·5	9·1	31·5	55·4
2000	600	4·0	5·2	20·4	32·3
2500	750	3·7	3·0	15·4	23·7
3000	925	3·2	2·2	11·1	18·3
3500	1100	2·0	1·3	8·8	13·6
4000	1275	1·7	1·0	7·9	12·1
7000	2425	3·3	1·5	4·8	6·7
9000	3325	7·0	4·4	5·9	6·3

Note: The apparent gain for low income families may be illusory at quite low incomes. As noted before the effect of the flat rate benefit levels combined with the flat rate stamp means that a married couple would be better off unemployed when income from employment was below about £1,300; a married couple with 2 children when income was below around £1,650 and a couple with 4 children when income was below about £2,000. Thus much of the gain at low incomes is due to the fact that the family incurs a loss relative to the social insurance system if employed at low incomes.

Thus tax would be levied on the weekly level of earnings and credits allowed or refunds made. If, for some period, a person became self-employed (or eligible for social assistance which, unlike benefit, would continue to be outside the tax net) no refunds of previous tax paid would be allowed. Similarly, the taxpayer would not be obliged to refund the cash element of any tax credit even though such cash grants are available only to the employed (including those on social insurance benefits). Although some persons would end up "over-paying" tax because of movements between employment and self-employment (or non-insured unemployment) others would gain through obtaining cash transfers while employed which would not be available to the self-employed.[1] The non-cumulative nature of the credit scheme could involve Exchequer Savings of up to £30 million at present paid out in refunds to those who become unemployed, to school children with summer jobs and to others leaving the tax net for a period of time. Thus the net cost of the refundable credit scheme might be reduced to about £52 million which, while substantial, is only about 75% of the full year cost of the 1977 income tax concessions.

5.12. The main advantages of the integration of the tax and social insurance code lies in the fact that the effective "marginal tax rate" on low paid employment is reduced for families with dependent children. Thus the take-home pay of a married man with 2 children earning 50% of the average male industrial wage[2] would be £39·52 per week (or 8·3% more than the basic wage of £36·50) compared to £32·41 under the present tax system and a benefit level of £29·05 under the present welfare code. The net gain to employment is £10·47 or 28·7% of gross earnings; this represents an effective tax rate on employment of 71% or so which is still high but substantially lower than the 91% "tax" rate applicable under the existing tax and transfer code. A married man with 2 children would be better off in any job paying at least £21·55 per week (the present flat-rate payment for a married couple with no dependants) compared to a break-even level of £32·30 under the existing tax code. This is because allowances for dependent children continue to be payable as cash grants or tax credits even when employed and the rate of withdrawal is only 30% or 35% of each £ earned. Thus for every pound earned over £21·55 (up to a total income of £48·08 per week or £2,500 p.a.) the cash grant payable per child is reduced by £0·30—the amount of tax payable in respect of the extra earnings. This compares with the 100% withdrawal rate at present where social insurance child allowances are not payable to persons who are employed.

[1]An interesting by product of the proposed scheme, which we do not explore here, may be the effect on the demand for employed status and the possible reversal of the present tendency, noted by many commentators, for individuals to seek self-employment status to avoid or evade more easily the rigours of the income tax code.

[2]Taken as £73 p.w. for 1977.

5.13. The main disadvantage of the scheme is its treatment of the self-employed and those on social assistance. The self-employed would be in a somewhat anomalous position being entitled to tax credits but not refunds of tax credits. Those on social assistance would still face "marginal tax" rates in respect of employment although far less than under the present system. There would still be fairly strong disincentives to single persons, and married couples with dependants to move from social insurance benefits to low paid or part-time employment because of the categorical nature of the transfer payments. The scheme would also cost about £52 million to implement compared to the present code.

5.14. We can see that by extending the concept of tax credit to allow for the possibility of refunds we have moved quite a distance towards the integration of the social welfare and income tax codes. But the levels of tax credit chosen are low in relation to existing benefits and so much of the present administrative structure of the two systems would have to continue unaltered. But the proposals would offer very real gains to those individuals and families on low incomes and would help increase the gap, especially for larger families, between income from employment and social welfare benefits. In the next chapter we turn to a scheme which is far more radical than those outlined in Chapter 4 and here. There we attempt to widen the scope of the system, the grant aspect of which was confined to those in employment in our discussion above. We also move from the dual nature of the tax credit as either a grant or an offset to tax to a single cash grant. By such an approach we can obtain a greater degree of integration within the entire social welfare and income tax code.

Chapter 6

AN INDIVIDUAL GRANT AND TAX SCHEME

6.1. The schemes examined so far do not represent very radical changes in either the tax or transfer schemes. On the income tax side we have simply replaced tax-free allowances with fixed value credits which can be used to offset tax liabilities. We have similarly restricted the extent to which interest and other payments can be used to reduce tax liabilities. We also changed the social insurance stamp from a flat rate selective tax to a universal proportional tax incorporated into the income tax code. On the social welfare side we made benefits taxable and allowed for cash grants to working families whose tax liabilities were less than the allowable tax credits. But the schemes we have examined so far still contain many of the features of our existing tax and transfer structure. These include the distinction between social insurance and social assistance, the categorical nature of most transfer payments, the exclusion of certain income from the tax base, and the rate of withdrawal of benefit at a 100% rate over a significant range of income. By confining our attention to those in employment we exclude a significant proportion of the population, namely, the self-employed, including the farming community. The exclusion of this section of the population has been an age-old feature of the tax/transfer system in Ireland and represents a major stumbling block on the path towards a comprehensive and integrated income tax and maintenance system for the country. As long as a significant proportion of the population, and a sizeable fraction of national income, remains outside the tax net while remaining within the income transfer system, it will be impossible, or exceptionally expensive, which probably comes to the same thing, to develop a single fully integrated tax/transfer system.

6.2. The difficulties imposed by the present structure of income taxation and welfare benefits should not inhibit us, however, from exploring

a more radical approach to the problem of taxes and transfers. In particular we shall examine a comprehensive integrated system which overcomes most, if not all, of the anomalies raised in Chapter 2 and which does not require a large and complex bureaucratic structure for its implementation. In considering such an integrated approach we are fortunate that the net amount of resources that have to be transferred away from personal incomes to finance other public expenditure is quite low in Ireland. As we saw earlier the net contribution of the income tax/income maintenance transfers system to other public expenditures was £240 million in 1977 or less than 5% of GNP.[1] Thus an integrated tax/transfer code which involved no net cost to the Exchequer, would have to result in a "surplus" of revenue over expenditure of £240 million.

6.3. Our earlier approaches to tax/transfer reform concentrated on the nature of personal allowances in the income tax code, the role of tax deductions in reducing tax liabilities but encouraging greater rate progressivity, and the taxation implicit in social insurance contributions. While the refundable credit proposal involved the incorporation of "social insurance" benefits into the tax code and, in a more complex way, the incorporation of child tax allowances into the insurance system the integration of tax and welfare was only partial. Persons who became unemployed etc., without the qualifying conditions for social insurance (i.e. sufficiently long periods of employment) would have to obtain unemployment assistance and so would be outside the tax/transfer scheme. Similarly, there would be little advantage for most beneficiaries in obtaining part-time work at pay less than the flat-rate benefit rates for single persons or married couples. One ought, if possible, to design a system which encourages rather than discourages the acceptance of whatever limited income-earning opportunities are open to the unemployed.

6.4 From the work incentive standpoint the best system would appear to be one where some basic level of benefit was payable to all, irrespective of income or employment status and all earnings or

[1]It could be argued that the 1977 net contribution is overstated in that the full year effects of the 1977 Budget changes would reduce income tax revenue by a further £20 million and raise social welfare expenditure by £30 million.

income were taxed at a relatively low rate. Such a tax and transfer combination has, in the literature, a distinguished history[1] but in spite of its intuitive economic appeal it has not been implemented in practice. One reason for this is that the problem of the "poverty trap" and the interaction between the tax and social welfare code has not, until recently, been particularly acute. There may also be fears that such a scheme would either be very expensive or else involve very high tax rates to finance the basic grant. In the Irish case fears about the tax rates are less valid because of the low degree of dependence of the state on net receipts from the tax/transfer system. Fears about the cost of such a scheme may also arise from the belief that if persons were guaranteed a minimum level of income they might choose a life of indolence at the expense of the State (i.e. others who do not choose indolence and so pay income taxes). Much would, of course, depend on the level of benefits established but it is difficult to see why such fears should exist. At present the safety net of social insurance and social assistance virtually guarantees a minimum level of income for all individuals in the State.[2]

6.5. The main elements of the proposals detailed below are the payment of a cash transfer to all persons within the community; the taxation of all employee incomes at a single rate, with no tax free allowances and no allowances for tax purposes of mortgage interest, superannuation, etc., the taxation of all other gross incomes at a slightly higher single rate; the conversion of employers' contributions to social welfare to a proportional tax on employee remuneration at a single rate. All incomes, including farm incomes would be in the new income tax base.

6.6. Before detailing the applicable tax and transfer rates it is useful to discuss the *rationale* for the main features of the proposals outlined in 6.5. The income transfer can be seen as identical to refundable tax credits are discussed earlier. However, all persons are entitled to these credits/payments and for the self employed and those on assistance direct cash transfers would be made. The reason why

[1]See for example Rhys Williams (1943), Tobin (1965), Green (1967) and Brown and Dawson (1969).

[2]Indeed the 1975 reform of Home Assistance provides a guaranteed right to minimum income levels for persons in Ireland.

a distinction has to be made between the aged and others and between those who have insured employment and others was because existing transfer schemes favour these groups. To apply the transfer level of these groups to the entire population would raise the cost of the scheme quite considerably. Once the tax/transfer scheme extended to the entire population, problems arise concerning the non-cumulative[1] nature of the income tax code. In our discussion of the refundable tax credit scheme we conceded that the non-cumulative aspect—which applied to those in employment—could lead to over-payment of taxes for those with variable earnings. To an extent this was offset by the fact that cash transfers made in periods of low income were not refundable by the tax payer. In a comprehensive system where some taxpayers would be assessed on an annual basis and others on a weekly basis clearly the problem of equitable treatment of taxpayers arises. With a single tax rate applicable to all income the problem of over-payments in a non-cumulative system disappears.[2] The desire to avoid administrative complexities combined with a wish to eliminate the erosion of the tax base led to the elimination of the tax deductibility of most items now eligible. In some cases this could have the secondary effect of raising the price of goods and services where such goods and services are supplied by individuals who rely on the tax deductibility of certain expenditure. Thus, for example, the cost of public relations consultants might rise if the tax deductibility of entertainment allowances were ended. (On the other hand, such an abolition might reduce the price of entertainment; much would depend on the relevant supply and demand elasticities). The inclusion of farm incomes was essential if the scheme was to be genuinely comprehensive.

6.7. The level of transfers and the applicable tax rate was determined under the following constraints; (*a*) no loss of income for those on existing social welfare or assistance, (*b*) no loss of income for

[1]See 2.22 earlier for a discussion of the cumulative nature of the existing PAYE tax code and 5.11 for a description of a non-cumulative code with refundable tax credits.

[2]Assuming, of course, that tax free allowances are no longer in effect. Thus if X% was the tax rate it would be paid on weekly, monthly or annual earnings regardless of the level or pattern throughout the year.

most taxpayers and (*c*) no major revenue loss to the Exchequer. Although the simplification of the tax code and the use of a single tax rate should lead to greater enforcement and compliance it would be inappropriate to assume a major gain in revenue on that score. The level of personal transfers is set as follows:

	£ per week
Employees aged over 18	13·00
Other persons aged over 18 (including self-employed, farmers, housewives)	10·70
Persons under 18	3·75

Employees would be defined in a manner similar to that suggested for the refundable tax-credit scheme. It would include those in employment, those unemployed who have been in employment for some qualifying period and who have been unemployed for less than some particular period (i.e. rules similar to qualifying rules for social insurance) and persons who would at present be eligible for retirement or contributory old age pensions. An additional allowance of £2·50 per week would be payable to *single* old age pensioners and to widows. Ideally, we would have preferred one individual transfer rate for all persons whether employed, widowed, aged or not. But that would have involved a basic rate of transfer of £15·50—the maximum available for old age pensioners over 80—and would have added £350 million to the cost of the scheme or 8·6 percentage points to the tax rate. Because those eligible for social insurance receive higher cash transfers than those eligible for social assistance under the present social welfare system, we had to distinguish between employees (i.e., those covered by social insurance), and others. To have given all persons aged over 18 years the transfer level set for employees would have added considerably to the cost of the scheme and required a substantially higher tax rate.

6.8. The selection of tax rates is somewhat arbitrary although the constraint of low revenue loss is considerable and greatly reduces the range of applicable tax rates. The following tax rates are suggested

	%
Employees liable under PAYE	34
Others paying tax annually in arrears	37
Employers social welfare contribution	9

It may be objected that employees face a lower tax rate than others; that could be explained by the one year lag in tax payments available to non-PAYE taxpayers which at an interest rate of about 9% would be worth 3 percentage points on the tax rate.[1] In fact the total tax on employee income is 43% when the employers contribution is taken in to account instead of the 37% for others. This differential can be justified, in part, by the higher level of transfer available—those employees earning less than £38·33 per week are better off if the employers tax is entirely borne by the employee.[2] If no employer tax was levied the total tax rate would have to be around 41% which would significantly raise the marginal tax rate for the bulk of taxpayers. The 9% levy on employers is slightly higher than the approximate 7½% levy implied by the existing flat rate contribution. Clearly any increase would have to take place in the context of general agreement on pay or else the cost to employers could have consequences for employment. To some extent aspects of the existing tax code forced us to adopt a tax structure which does not exactly correspond to our ideal just as aspects of our transfer structure meant certain compromises from the ideal of a single set of transfers.

6.9. The aggregate cost of the scheme was based on the demographic estimates in Table 6.1. The dividing line between employee and others status is difficult to draw and so the estimates must be considered approximate.

In addition to the aggregate annual cost of transfers of £1,439·4 million a further £30 million would be required to pay the extra allowance to single old age pensioners and to widows. Thus the total aggregate cost of transfers would be £1,469·4 million compared to an estimated 1977 level of £520 million.

6.10. Calculation of the tax revenue yield is somewhat more complicated. First, we had to make assumptions about the coverage of the tax base i.e. the proportion of income, measured on a National

[1]This does not take account of the fact that incomes may also be growing over time which makes taxation on a retrospective basis of even greater advantage to the taxpayer.

[2]That is a person earning less than £38·33 per week would be better off with a transfer of £13·00 and a tax rate of 43% than with a transfer of £10·70 and a tax rate of 37%.

TABLE 6.1

Population Structure, Weekly Transfer and Aggregate Annual Cost

Category	Numbers (000 s)	Weekly Transfer £	Annual Cost £ million
Employees (including certain unemployed and aged)	900	13·0	608·4
Others (including self-employed, housewives etc.)	1,080	10·7	600·9
Persons under 18	1,180	3·75	230·1
Total	3,160		1,439·4

Accounts basis, included in the tax net. We assumed that 90% of all wage and salary income would come into the tax net—the balance would represent income under double tax agreements, income not declared to the authorities etc. For farm incomes the coverage was assumed at 85%. We assumed that, as a transitional measure, farmers would be given the option of being taxed at 90% of the average income per £ valuation rather than an actual income. This, combined with the use of accounts by those with incomes below the national average per £ valuation and tax allowances for depreciation etc. in excess of the National Accounts estimates would reduce the amount of income coming into the tax base. Some 80% of income from self employment is assumed to come into the tax base. The gap is accounted for by export profits tax relief on dividends, depreciation and capital allowances in excess of those set out in the national accounts framework, and the probability of some tax evasion even at a single, relatively low, tax rate.[1] Thus Table 6.2 sets out the level of personal income, on a national accounts basis, and the share of such income likely to be included in the comprehensive tax base. The revenue from each component is also calculated.

[1]The probability of evasion would be greatly reduced if severe penalties were imposed on tax evaders and if the manpower at present devoted to administering the present complex tax system were used to detect evasion.

TABLE 6.2

Estimated 1977 Personal Income by Source, Estimated Tax Base and Projected Tax Revenues

Income Source	Present Income £ million	Tax Base Share £ million	Tax Revenue £ million
Wages and Salaries	2,950	2,655	1,141·7
Farm Incomes	740	629	232·7
Other Incomes	850	680	251·6
Total	4,540	3,964	1,626·0

Source: Income data based on Central Bank *Quarterly Bulletin*, Summer 1977 and the ESRI *Quarterly Economic Commentary*, September 1977. Other incomes include wage and salary income from abroad.

The total expected revenue yield is £1,626 million so that the system could deliver a net £156·6 million to the Exchequer compared to £240 million under the present arrangement. Thus the net cost of the scheme would be £83·4 million.[1] This represents a considerable revenue loss but it must be remembered that the proposed grant/tax scheme meets all EEC requirements with respect to equal treatment of women in social security and ends discrimination in respect of the tax treatment of married persons relative to single persons. To implement the EEC requirements could cost between £8½ and £31½ million over the

[1]It might be argued that the scheme would cost more since the revenue yield is based on 1977 income levels whereas non-wage and salary taxes are paid one year in arrears. However, we have designed the scheme to be comparable at October 1977 benefit levels, the full year cost of which has yet to be borne and at 1977/78 tax rates the full year cost of which is not borne in 1977. If we assume that wages and salaries will be 12½% above the 1977 annual level in 1978/79 and that transfers are increased by 5% in both April 1978 and October 1978 (i.e. held constant at October 1977 real levels) then the net cost to the system in 1978/79 would only be £50·89 million, i.e., increased tax revenue from wages and salaries of 12½% or £142·71 million less increased transfers of 7½% or £110·2 million yield an extra £32·51 million for net revenue. However, the proper basis for comparison ought, perhaps, to be the 1978/79 net contribution of the tax/transfer system for general government revenue. If this exceeded £240 million then the net 1978/79 cost of our proposed scheme would be greater than £50·89 million.

next four years.[1] The abolition of discrimination in the tax treatment of married persons could be equally expensive. Thus in the context of these changes in the tax code—one of which will have to be implemented in the near future—the total net cost of the scheme is not great. On the other hand, it is probable that some of the transfers included in the "income maintenance" category involve certain personal social services which could not be replaced by individual cash transfers and so it might be best to assume a net cost, in a full tax year, of around £80 million.

6.11. Given the wholly different nature of the individual grant and tax system it is difficult to make comparisons with existing tax structures. It is not very meaningful to compare tax burdens when it is known that the relief given to high income individuals is offset by the non-deductibility of certain expenses. However, we have set out in Figure 6.1 comparisons between the existing tax code and the proposed scheme. When deductions are ignored we can see that at all points on the income scale after-tax (and transfer) disposable income is greater under the new scheme. However, some farmers, not at present liable to taxes, would lose[2] as would those with a relatively high ratio of deductible expenditure to gross income. We have also set out in Appendix Table A 3 some examples of the gains/losses in after tax income for different income levels.

6.12. In principle the proposed scheme should be relatively simple to administer. Admittedly the distinction between "employed" and other categories adds something to the administrative complexity. For those in employment the individual grant would be payable by the employer.

[1]This estimate was contained in the report on the EEC directive by the Joint Oireachtas committee on Secondary Legislation. On one interpretation the implementation of the directive could involve allowing married women who were unemployed to claim unemployment benefit allowances in respect of dependent children while their husbands continued to claim both wife and children as dependents for income tax purposes. Indeed, unemployed married women could claim as dependants husbands who work just as, at present, unemployed married men can claim a dependency social welfare allowance in respect of working wives.

[2]The scheme would be, broadly, redistributive in its effect on the farming community i.e. most of the increase in tax would go to finance higher transfers to the farm sector.

Each individual would, normally, be entitled to a grant only in respect of him (her) self. In cases of low paid employment the employer would reclaim the net cost of the transfer (i.e. the grant less the 34% tax earnings and the 9% employers' contribution) and arrangements could be made to aid employers with acute cash flow difficulties because of the transfers. For those who are unemployed, but have work qualifications similar to those required for social insurance benefits, the grants would be payable through existing employment exchanges and social welfare offices. For other, including self-employed, housewives, retired persons etc., the grant would be payable through the post office as in the case of children's allowances. Child allowances would be payable to the mother (although assignable to the father) through the post office. Payment cards could be issued to all persons over 18 within the State. These cards would identify the individuals' status with respect to grant level and family size. They would be held by employer or employment exchange in the case of employees and would be presented weekly for payment at post offices in other cases.

6.13. The operation of the scheme might best be explained by taking the example of a married man with 2 children earning £75 per week. At present, his take-home pay is £59·40 if we assume he has no deductible expenses. If we allowed him £500 expenses for mortgage and other interest payments and pension contributions his take-home pay would rise to £62·77 per week. In addition, his wife can collect, through post office childrens' allowances, the weekly equivalent of £1·48. Now consider the introduction of the new scheme. Thus, the husband would now take home £62·50 which is equal to 66% of £75 plus the £13·00 personal grant. In addition, the wife would be able to collect £18·20 at the local post office being the sum of the £10·70 allowance for non-employed persons plus £7·50 for two children under 18. In this example the family would be significantly better off and the wife would receive an allowance in her own right, rather than as a concession on her husband's income tax certificate. If the family had mortgage interest relief well in excess of £500 the take-home pay of the husband would be lower under the new scheme than under the existing tax system—but total family income would still be higher in the new system.

6.14. Suppose now our employee with 2 dependent children, became unemployed. Under the present system he would receive £30·53 flat rate benefit plus, if qualified, some pay-related supplement and income tax rebates up to a maximum of £50·49 if there are no mortgage etc. expenses and £53·35 if there are. Under the new proposals it would be entirely possible, although more expensive in terms of employee and employer contributions, to continue with pay-related benefit. Our proposals relate only to the flat rate component of social welfare. Thus when the employee becomes unemployed under our proposals he would receive a flat rate allowance of £13 per week while his wife would continue to collect £18·20 at the post office. This would give a flat rate benefit of £31·20 or slightly higher than the present level. On the other hand, no refund of tax would be available because of the non-cumulative nature of taxation of employment income. However, if the husband found some part-time work at, say, £10 per week then the family income would rise by £6·60 (i.e. the £10 less 34% tax) whereas under the present code such earnings would be in breach of unemployment status or would be matched by a withdrawal of payment of equal amount.

6.15. One possible long-term advantage of the proposed scheme is the greater protection it offers against the impact of inflation on real tax rates. The use of a proportional tax rate ensures that the tax

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FIG 6.1

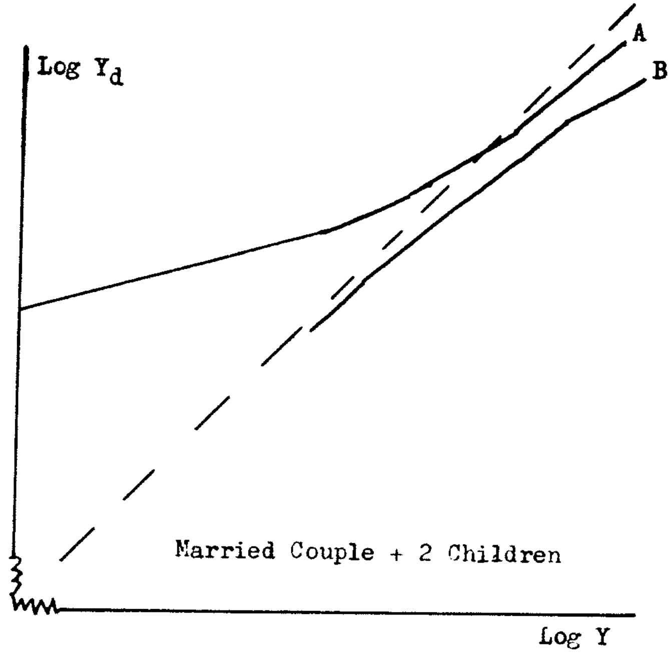
Comparsions of After Tax Income Under Existing and Proposed Tax/Transfer Schemes

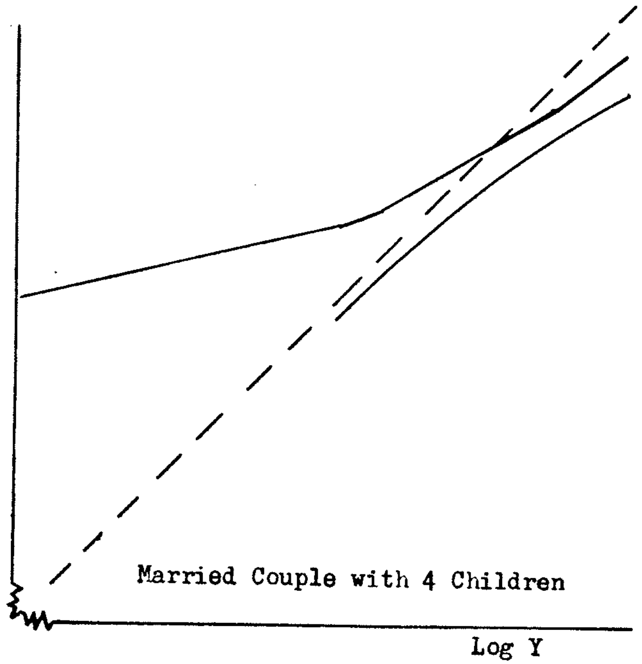
A is proposed individual transfer and single rate tax proposal as outlined in text.

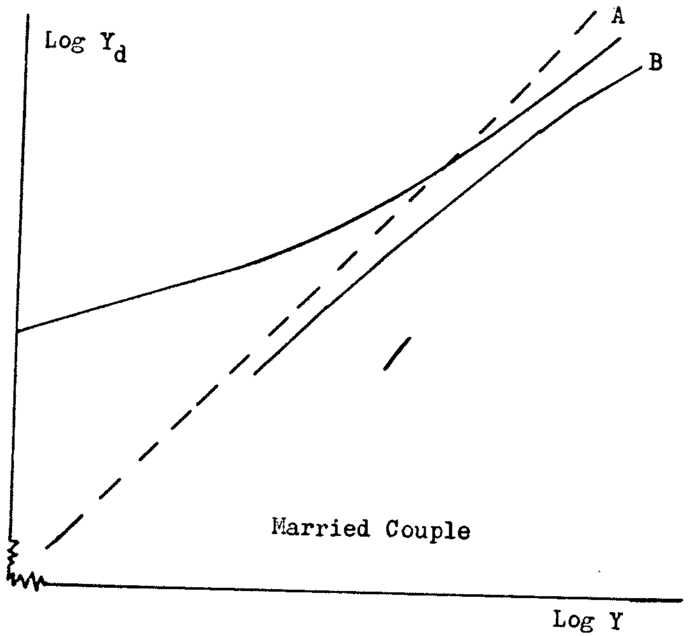
B is existing tax code at 1977–78 rates and allowances.

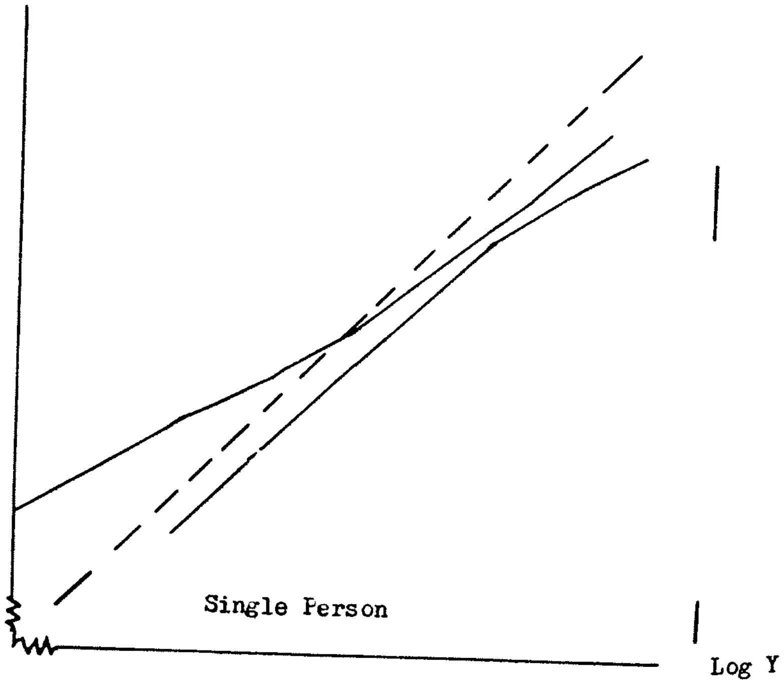
For the purpose of comparison each unit is assumed to have one, and only one, employed member.

Y_d is employment income after tax and social insurance contributions. Y is pre tax income. The dashed line is a 45° line showing points where before and after tax incomes are equal. A log scale is used to illustrate the impact of the proposed scheme on low incomes.









levied will not increase in real terms due to an increase in prices. As the transfer levels represent basic income levels for some groups there is a greater likelihood of indexation than would be the case with tax-free allowances.[1] For the bulk of taxpayers the proposed scheme reduces the marginal tax rate on additional income (although only fractionally for the majority of taxpayers on the 35% marginal rate). It also reduces to 34% the tax on earnings from part-time or low paid employment for those who would, at present, be eligible for social insurance or social assistance. By eliminating the deductibility of many items used to reduce existing tax burdens it expands the tax base and makes possible a relatively low, uniform tax rate. This, in turn, should aid enforcement both because of the reduced incentive to evade and the easier enforcement of a single rate tax.

6.16 It is also worth noting that the proposed scheme answers many of the objections raised by women (single and married) to our existing tax and social welfare laws. Single women would qualify for grants on the same basis as men; there would be no contribution conditions. Married women who work would be taxed on their income as if they were single i.e. they would pay the same 34% tax rate and receive the same employee grant of £13. Married women who do not work would be treated on a par with all self-employed persons; indeed they would get a "housewives' allowances" in addition to substantially increased child allowances.

6.17 The scheme has considerable advantages for the working poor and for those at present on social welfare benefit or assistance who might have some part-time income earning opportunities. Thus there is no longer any "break-even" level of income i.e. employment at even £1 per week will increase disposable income because the individual grant is not withdrawn and the marginal tax rate is 34%.

[1]Although we noted in Chapter 2 that benefit levels were close to or exceeded tax free allowance levels for many categories of beneficiaries. Thus a policy of indexation of social welfare benefits would either imply a policy of indexation of tax-free allowances or else a growth in the magnitude of the anomalies described in Chapter 2.

6.18. In this chapter we have described a fairly radical approach to the whole question of income taxation and social welfare. Put in very simple terms our proposal involves giving everybody social welfare payments and taxing all incomes at a standard rate. Admittedly we had to have certain refinements, not least to allow for the existing pattern of social welfare payments. Clearly the system would involve some losses and some gains. We have tried to minimise the losses to easily identifiable groups of taxpayers; the strength of the opposition to the proposals will, in part, be a reflection of the extent to which we have succeeded or failed in our efforts. The cost, broadly estimated at around £80 million, is not a small sum although it is small in relation to the relative cost of such integrated schemes in other economies which rely on a greater flow of net revenue from the income tax and transfer system to finance other government expenditure. Perhaps the main advantage of our proposal is that persons can readily calculate their tax liabilities and know exactly how much they are getting from, or putting into the system. Although the proposal would greatly increase the gross flows and tax and transfers through the system—the net flow would, however, be reduced—these flows would be transparent. In the past we have tended to become prisoners of a piecemeal and incremental approach to tax and social welfare reform; the result has been the development of an amazingly complex and bureaucratic system. It seemed worthwhile to map out, however sketchily, some interesting alternatives.

Chapter 7

SUMMARY AND CONCLUSIONS

7.1. In the preceding chapters we attempted to describe alternatives to the present income tax and social welfare code. We saw in Chapter 2 that the present system, even when pay related benefits and redundancy payments are excluded from consideration, can give rise to a relatively high effective tax rate for low income earners, especially those with large families. This high tax rate (or more properly tax and withdrawal of benefit rate) is the result of a number of different factors including the flat rate nature of social welfare contributions, the fall in the real value of personal tax free allowances, the real increases in benefit and assistance levels, the relatively high marginal tax rates that are part of the income tax code, and the absence of any mechanism for transferring income to the working poor. We suggested that only an integrated approach to income tax and income transfers could prevent the possibility of permanent "poverty trap" where there was a zero (or negative) return to employment for some families.

7.2 Only the third of our proposals, the most radical, could be said to represent a fully integrated approach. The non-refundable tax credit scheme reduces some sources of anomalies on the income tax side; the refundable tax credit scheme integrates, to a considerable extent, the social insurance code and the income tax code, but does not include social assistance payments. The individual grant and tax scheme represents a complete integration although it must be conceded that the increased grants available to employees, old age pensioners and widows represent features of the present unintegrated system which we would have preferred to avoid. However, we were constrained by cost factors in our choice of schemes and the details of each.

7.3. In Table 7.1. we have set out a summary of the alternative schemes proposed. It is probably fair to say that the proposals for the replacement of tax free allowances with tax credits is the least radical of all. However, the introduction of a refundable credit would be a significant alteration in the present large divide between the tax code and income transfer arrangements. The third option, of converting allowances into tax free cash grants, is of course a major alteration to the present system. Similarly, the restriction of allowances in respect of pensions, contributions, mortgage and other debt interest to a tax credit evaluated at a fixed tax rate is not particularly radical although those with significant expenditures of this type, with marginal tax rates of 50 or 60 per cent might differ. However, even they may be prepared to trade-off the exiisting ability to claim these expenditures against taxable income for a reduction in tax rate. Again the third option is the most radical with a complete abolition of the tax free status of such expenditure. The quid pro quo for the high income earned is a significant drop in the marginal tax rate; for the lower income earner the withdrawal of concessions might well be offset by the high level of untaxed cash grants available.

7.4. Only in the individual grant and tax scheme are social welfare payments fully integrated with every individual obtaining a grant in his or her own right. In the non-refundable tax credit scheme the existing social welfare code continues while in the refundable credit scheme benefit payments would be taxed although this would not lead to reduced income for those relying on such payments alone. However, social assistance payments would remain unaffected and there would still be the same administrative structure required to make social welfare payments and ensure that, for example, unemployed persons on benefit or assistance were not acting in breach of the detailed regulations of the social welfare code. All three schemes, however, involve the incorporation of employee social welfare contributions into the general tax code although only in the credit schemes is such incorporation made explicit. The individual grant and tax scheme would involve a pay related contribution by employers; the other schemes did not deal with this issue although it would clearly make sense to convert a pay related basis, if the flat rate employee contribution was abolished.

TABLE 7.1

Alternative Tax and Transfer Schemes

	Non-Refundable Tax Credit Scheme (Chapter 4)	Refundable Tax Credit Scheme (Chapter 5)	Individual Grant and Tax Scheme (Chapter 6)
Tax Free Allowances	Converted into a tax credit, i.e., a fixed sum which can be used to offset tax liabilities based on gross income. The credits are non-refundable so a taxpayer whose liabilities are less than the credit does not get a cash grant equal to the unused portion.	Converted into a tax credit. The credits, which are higher than those for the non-refundable scheme, are refundable. A taxpayer who has tax liabilities less than the value of the credits gets a cash grant from the Exchequer equal to the difference. Refundability applies only to employees.	Abolished. Replaced by a non-taxable personal cash grant.
Expenditure on mortgage, consumer debt interest, superannuation, etc.	Converted into tax credit by multiplying expenditure by lowest applicable tax rate, i.e., 20%	Converted into tax credit by multiplying expenditure by lowest applicable tax rate of 25%.	Not allowed as deduction for income tax purposes.
Social Welfare Payments	No change in present system.	Social welfare short term benefits are taxable. Tax credit levels ensure that no tax is payable if only source of income is social welfare. No change in social assistance code.	All social welfare and social assistance payments replaced by individual grant with supplements for old age, widows and employees.
Social Insurance Contributions	Employee contributions abolished and replaced by general 5% levy on all taxpayers integrated into tax structure. Employers' contributions may be changed to pay related but this is not part of proposal.	Employee contributions abolished and integrated via 5% levy on all taxpayers into the general tax code. Employers' contributions may be changed to pay related but this is not part of proposal.	Employee contributions absorbed into general tax structure. Employers' contributions replaced by general 9% payroll tax.
Tax Rates	Varies from 25 per cent to 50 per cent (including social security levy). Tax payable on all Income but no deductions. Tax credits reduce computed gross liability.	Varies from 30 per cent to 55 per cent (including social security levy). Tax payable on all Income with no deductions. Tax credits reduce computed gross liability.	Tax on employee income at 34%. Tax on income from self-employment 37%.
Tax Base	As for existing tax code. Refunds allowed for overpayment of tax under PAYE if working year is interrupted.	As for existing tax code. No refunds of tax allowed in respect of employee income where employment in tax year is interrupted. However, tax credit becomes payable as cash grant.	All incomes including farm incomes. Transitional arrangement for farm incomes through notional multiplier.
Net Cost to the Exchequer of Proposals	—Nil—	£54·5 million	£83·4 million

7.5 In our examination of the various schemes we concentrated on the likely microeconomic effects of the proposals. That is, we dealt mainly with comparisons between after-tax income under the existing and proposed schemes. But we did not deal with the effect of the implementation of such schemes on the economy as a whole. There are a number of reasons for this. The first is that such an examination would be a major study in itself and could not properly be undertaken in the time and space available. A second is that we do not have enough information about the determinants of most macroeconomic aggregates to evaluate the likely impact of the tax/transfer alternatives. The third reason is that there are certain advantages in treating the macroeconomic problem as a separate issue and in assuming that other, non tax, policy instruments may be open to the Government to offset any undesirable macreconomic effects of the tax changes.

7.6. However, it is likely that most concern will centre on the impact of the curtailment (or abolition) of the tax concessions on mortgage interest payments on the construction industry. It must be stressed that the effective demand for housing depends *inter alia* on the supply of finance to home-buyers, on the level of income available to would-be purchasers, on the gross interest cost of any mortgage finance, on the relative price of housing, and on the degree of tax concessions available. Our proposals would tend to reduce the last item but would tend to increase the level of after tax income for most taxpayers. Thus the income effect could help offset the loss of tax advantages. One suspects that the long-term consequences for the demand of housing would be small as the major detriment is likely to be the trend in population and household formation; nor should it be forgotten that the reduction in tax rates for higher tax payers could encourage investment in new construction for renting purposes.

7.7. Another concern might be the effect on savings behaviour of the curtailment or abolition of tax advantages for pension and other contributions. Here again the income effect would help offset the substitution effect caused by the loss of tax concessions. In addition a significant proportion of the flow of resources into pensions and life assurance represents a long-term planning commitment which may not be much affected by current tax policy. Thus an individual who pays into a pension scheme to ensure a pension, related to his pay, at the end of his working life is unlikely to decide to forego a pension merely because his contributions are not tax deductible.

7.8. Underlying our approach has been the notion that, for any given net revenue yield, it would be desirable to have a tax and transfer code which would protect those without jobs or incomes from poverty, which would not impose enormous disincentives to work at either the top or bottom of the tax code, which would be capable of being understood by the population as a whole, and which would leave taxpayers as much freedom as possible to dispose of their incomes as they see fit. It is inevitable that our attempt will cause discussion and debate; one person's tax reform is so often another's tax nightmare. We have not attempted to present a detailed set of tax and social welfare laws; instead we have presented a framework within which discussion (and action) about the relationship between income tax and social welfare should develop.

APPENDIX TABLE A 1

Income Taxation under Existing Tax and SocialWelfare Code and under Non Refundable Tax Credit Scheme for various Income groups and Family sizes.

£ per week

Weekly Income	SINGLE PERSON			MARRIED COUPLE		
	Existing Income and Social Welfare Tax	Income and Social Security Tax in New Scheme	Tax saving	Existing Income and Social Welfare Tax	Income and Social Security Tax in New Scheme	Tax Saving
20	4·31	4·04	0·27	2·87	1·73	1·14
30	6·69	6·54	0·15	4·64	4·23	0·41
40	9·19	9·04	0·15	7·10	6·73	0·37
50	12·53	11·64	0·89	9·60	9·33	0·27
60	16·03	14·64	1·39	13·10	12·33	0·77
70	19·53	17·64	1·89	16·60	15·33	1·27
80	23·03	20·64	2·39	20·10	18·33	1·77
90	26·53	23·64	2·89	23·60	21·33	2·27
100	30·10	26·83	3·27	27·10	24·52	2·58
150	53·95	45·10	8·85	49·50	42·79	6·71
200	83·95	65·45	18·50	78·93	63·14	15·79

APPENDIX TABLE A1 (con't.)

Weekly Income	£ per week					
	MARRIED COUPLE WITH 2 Children			MARRIED COUPLE WITH 4 Children		
	Existing Income and Social Welfare Tax	Income and Social Security Tax in New Scheme	Tax saving	Existing Income and Social Welfare Tax	Income and Social Security Tax in New Scheme	Tax Saving
20	2·87	Nil	2·87	2·87	Nil	2·87
30	2·87	0·96	1·91	2·87	Nil	2·87
40	4·79	3·46	1·33	2·95	Nil	2·95
50	7·29	6·06	1·23	4·99	2·21	2·78
60	9·87	9·06	0·81	7·49	5·21	2·28
70	13·37	12·06	1·31	10·14	8·21	1·93
80	16·87	15·06	1·81	13·64	11·21	2·43
90	20·37	18·06	2·31	17·14	14·21	2·93
100	23·87	21·25	2·62	20·64	17·40	3·24
150	44·89	39·52	5·37	40·52	35·67	4·85
200	73·39	59·87	13·52	67·85	56·02	11·83

Note: All taxpayers are assumed to be in insurable employment. For married couples the wife is assumed to be not working. No deductions for mortage interest etc. is assumed. Thus the tax savings are overstated for those on higher incomes with considerable expenditure on tax deductible items.

APPENDIX TABLE A2

Tax Savings, Relative to Existing Tax and Social Welfare Code, under Proposed Refundable Tax Credit Scheme

Tax Savings* £ per week

Weekly Income	Single Persons	Married Couple	Married Couple with 2 children	Married Couple with 4 Children
20	2·23	3·34	10·88	17·04
30	1·61	2·11	7·84	14·04
40	1·11	1·57	6·76	11·04
50	1·35	0·97	6·16	10·07
60	1·35	0·97	5·24	9·07
70	1·35	0·97	5·24	8·22
80	1·35	0·97	5·24	8·22
90	1·35	0·97	5·24	8·22
100	1·23	0·78	5·05	8·03
150	4·31	2·41	5·30	7·14
200	5·72	8·99	10·95	11·62

Note: All Taxpayers assumed to be in insured employment. For married couples wife is assumed to be not working. No deductions for mortgage interest etc. is assumed. This overstates the tax savings to those on higher incomes with a relatively high amount of deductible expenditures.

*In the calculation of tax savings the refundable element of the tax credit was included. Thus a low income taxpayer might move from paying tax of, say, £2·87, to receiving a grant of £8·01 which would yield a tax saving of £10·88.

APPENDIX TABLE A.3

Tax savings under the Proposed Individual Grant and Tax Scheme for Different Incomes and Family Sizes

Tax Savings* £ p. w.

Weekly Income	Single Persons	Married Couple	Married Couple with 2 Children	Married Couple with 4 Children
20	10·51	19·77	27·27	34·77
30	9·49	18·14	23·87	31·37
40	8·59	17·20	22·39	28·05
50	8·53	16·30	21·49	26·69
60	8·63	16·40	20·67	25·79
70	8·73	16·50	20·77	25·04
80	8·83	16·60	20·87	25·14
90	8·93	16·70	20·97	25·24
100	9·10	16·80	21·07	25·34
150	15·95	22·20	25·09	28·22
200	28·95	34·63	36·59	38·55

Note: Assumptions are as in Table A2. The exclusion of all deductible expenditure in this scheme makes comparisons more difficult as all taxpayers with expenditures on mortgage interest, superannuation contributions etc. would have to offset the gains above by the loss of the benefit of deducting these items for tax purposes. We should also note that universal child allowances payable through the post office (i.e. existing children's allowances) would be replaced in the scheme. Thus the gains above should be reduced by £1·48 p.w. for couples with 2 children and £3·72 p.w. for couples with 4 children.

*Savings defined to include grants as for Table A2.

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