An Roinn Airgeadais
Department of Finance

Economic Context for Taxation Policy

Tax Strategy Group – 22/01

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www.gov.ie/finance

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[1] The data and analysis set out in this document are compiled by Department of Finance staff. Every effort is made to ensure accuracy and completeness. If errors are discovered, subsequent corrections and revisions are incorporated into the digital version available on the Department's website. Any substantive change is detailed in the online version.

1 Introduction

1. This Tax Strategy Group (TSG) paper sets out the economic and fiscal context for taxation policy.

2. Taxation policy plays a fundamental role in ensuring the sustainability of the public finances – a core objective set out in the Department of Finance's *Statement of Strategy.*[2] The Department is responsible for achieving a sustainable economy and sound public finances *inter alia* through taxation related-tasks assigned by Government including:
   - A sustainable, growth-friendly, efficient and equitable tax system;
   - An enhanced international tax reputation including corporate taxation; and,
   - A supportive taxation environment for enterprise and employment.

3. Last year, the taxation system raised over €68 billion, which was more than €9 billion ahead of the previous highest yield reached in 2019. These monies were used, along with other revenue and the issuance of government bonds, to finance public expenditure of just under €106 billion.[3]

4. The economic and fiscal context within which the taxation system operates is crucial. While the short-term outlook is characterised by very high levels of uncertainty, related to the impact of Russia's invasion of Ukraine, it is also clear that the economy is entering a period of potentially significant structural change. Fiscal revenues are set to evolve at a slower rate over the medium-term. In addition, it is clear that there is a different borrowing environment on the horizon. Furthermore, financing will be required to address medium-term challenges along with ongoing public service needs.

5. Thus, taxation policy has an essential role to play – ensuring policy has a growth-friendly and fiscally sustainable orientation will be critical.

[2] Available at: https://assets.gov.ie/122270/1d8bd1ca-295f-42b2-9998-1c83ae04e716.pdf

[3] See: https://assets.gov.ie/218441/34485d61-0898-4e6d-bba1-ae956da2ed1e.pdf

2 Economic and Fiscal Context

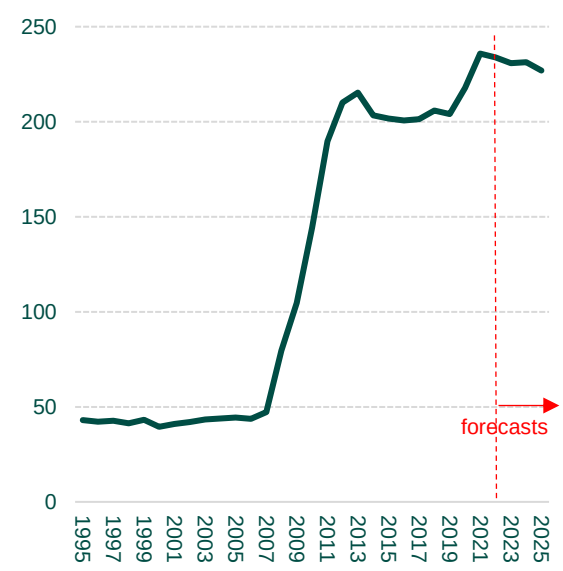
2.1 Budgetary Constraints: Debt Overview

6. Taxation policy formulation occurs within a broader macroeconomic and fiscal context, including the Government's overall strategy for managing the public finances. In the last two years, in Ireland, as in other advanced economies, public debt was allowed to increase substantially, as emergency measures were introduced to mitigate the impact of the Covid-19 pandemic.

7. At the end of 2021, gross public debt in Ireland was estimated at €235.9 billion, equivalent to €47,140 per capita, or 105.6 per cent of GNI*. Despite the high debt level, several structural factors, such as a relatively low (average) interest rate and elongated maturity profiles, have helped to limit the burden of this debt.[4]

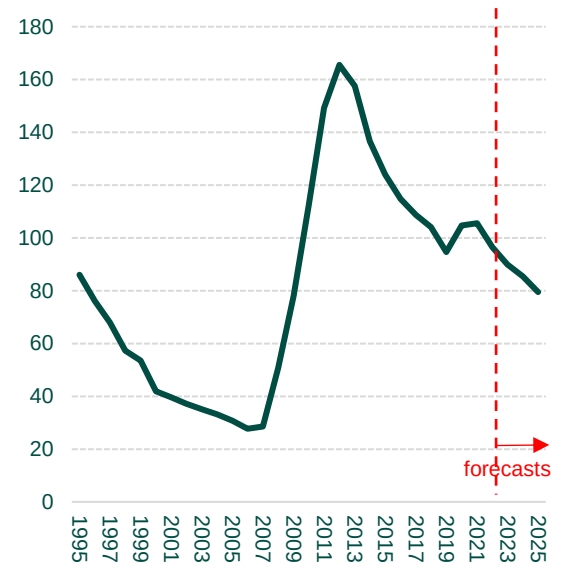
Figure 1: gross public debt

A: €, billions



Source: CSO, Department of Finance.

B: per cent of GNI*



Source: CSO, Department of Finance.

[4] Available at: https://assets.gov.ie/222651/994836b7-c9a9-4557-9ecc-b66f8b0e23c4.pdf

8. The *Stability Programme Update 2022* projects gross public debt to decline to about €227 billion over the medium-term, equivalent to 79.4 per cent of GNI*, and €23 billion higher than the pre-pandemic level. In addition, a number of structural fiscal headwinds are already visible on the horizon, including in the form of population ageing, reform of international corporation tax, and the 'twin transitions' of climate change and digitalisation.[5]

9. In addition, it is clear that we are entering a different borrowing environment. Central banks across advanced economies, including the ECB, are tapering asset purchases, with borrowing costs beginning to rise. In this context, further debt accumulation would increase fiscal vulnerability. As such, the Government's fiscal strategy involves slowing the pace of debt accumulation to ensure interest expenditure does not negatively impact economic growth and living standards.[6]

2.2 Future Challenges

2.2.1 AGEING POPULATION

10. Ireland's demographics are set to change significantly over the coming decades. Analysis by the Department of Finance shows that the old age dependency ratio is set to almost double by 2050. Whilst the pace of growth of the working-age population slows, the rate of economic growth will moderate as additional labour supply becomes scarcer. This will result in slowing tax revenue growth.[7]

11. In addition, Ireland's population structure will transition from one of the youngest in the EU to one of the most rapidly ageing EU Member States.[8] Age-related expenditure is projected to increase by 3½ per cent of GNI* by the end of this decade and by 8 percentage points of GNI* by the mid-point of the century.[9] Thus, significant structural reforms (e.g. increasing the state pension age) and changes to taxation policy through facilitating an increase in the participation of older workers and boosting productivity (e.g. R&D tax credits incentivising innovation) will be required to support this transition.

[5] Ibid.

[6] Ibid.

[7] Available at: https://assets.gov.ie/198456/1c05826e-5682-4537-952d-fce5abb6db33.pdf

[8] Ibid.

[9] Ibid.

2.2.2 DIGITAL TRANSITION

12. The *Programme for Government*[10] and the *Harnessing Digital*[11] framework commit to enhancing the digital transition across the Irish economy and society. This transition will bring significant benefits, along with fiscal challenges.[12] Investment will be required to support the transition of the economy, work force and business. Digitalisation could also see structural shifts to the economy. For instance, a continued emphasis on e-commerce transactions could impact the 'bricks and mortar' retail sector and, thus, employment, and income tax revenue.

13. In addition, there will be fiscal implications arising from the recent OECD Inclusive Framework on BEPS agreement to address the tax challenges arising from the digitalisation of the economy. While the agreement should bring stability and certainty to the international tax framework, it will negatively impact future corporation tax receipts.

2.2.3 GREEN TRANSITION

14. The *Programme for Government*[13] and the *2021 Climate Action Plan*[14] set out the Government's ambition to achieve a 51 per cent reduction in overall greenhouse gas emissions by 2030 and to put Ireland on the trajectory to reach net-zero emissions by no later than 2050. This necessitates a suite of actions to foster a shift from fossil fuel usage towards alternative fuels and technologies. This will entail investment in green initiatives, and the use of taxation to incentivise a change in behaviour. Taxing externalities, such as the use of carbon taxes, will play an important role in supporting efforts to lower emissions. The Minister for Finance has set out a pathway for the price of carbon to reach €100 per tonne by the end of this decade in legislation.[15]

15. In summary, the challenges outlined in this section highlight the importance of effective medium-term planning, whilst facilitating investment in key areas of the economy, such as the twin transitions. This will require significant structural reform, responsive taxation policy, and sustainable public finances.

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[10] Available at: www.gov.ie/en/publication/7e05d-programme-for-government-our-shared-future/

[11] Available at: https://www.gov.ie/en/publication/adf42-harnessing-digital-the-digital-ireland-framework/

[12] See: https://doi.org/10.1787/dec600f3-en, and www.ecb.europa.eu/pub/economic-bulletin/focus/2018/html/ecb.ebbox201807_04.en.html#:~:text=This%20survey%20%E2%80%93%20the%20ECB%20Digitalisation,interaction%20with%20institutions%20and%20governance.

[13] Available at: www.gov.ie/en/publication/7e05d-programme-for-government-our-shared-future/

[14] Available at: https://www.gov.ie/en/publication/6223e-climate-action-plan-2021/

[15] Ireland's legal obligations involve a 51 per cent reduction (relative to 2018 levels) in carbon emissions by 2050. Government has adopted the *Climate Action Plan* in order to achieve this, available at:: www.irishstatutebook.ie/eli/2021/act/32/enacted/en/print

3 The Taxation System in Ireland

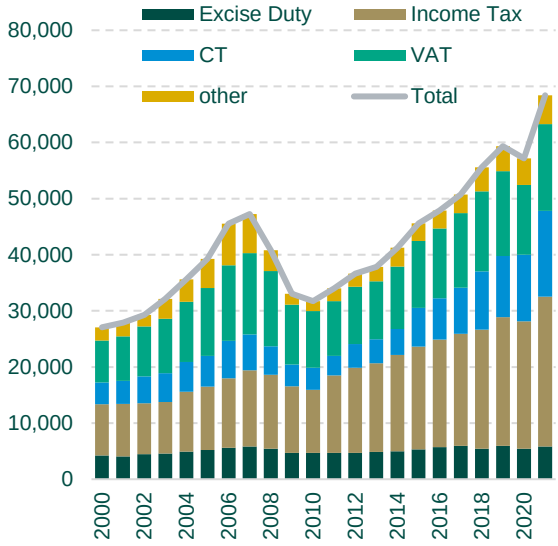
3.1 Trends in Taxation Revenue

16. The taxation system has evolved significantly over the past two decades, both in terms of size and composition (**figure 2**). Overall, taxation receipts have increased over the period, with aggregate taxation in 2021 around 2.5 times the level in 2000. There were just two periods were aggregate tax receipts fell – the first during the economic crisis between 2008 to 2010, and the second with the Covid-19 pandemic in 2020.

17. Income tax receipts represent the largest share of taxation revenue, and have grown over the period reaching 39 per cent of the tax take last year (**figure 2**). VAT captures the second highest portion of taxation revenue, though its share has fallen over time to 22.6 per cent in 2021.

Figure 2: tax revenue

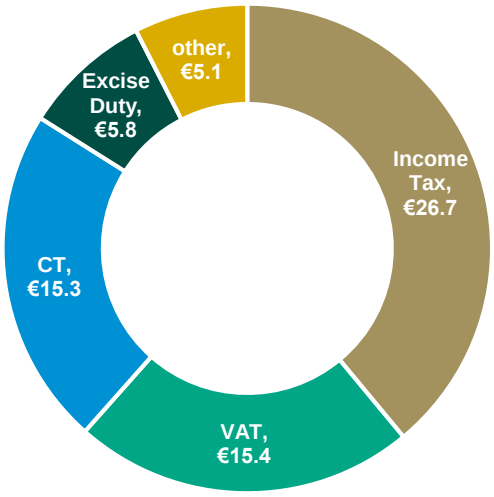
A: tax receipts, 2000-2021, € million



CT: corporation tax, other includes volatile revenues linked to the property market such as capital gains tax and stamp duty. From 2011, income tax includes the Universal Social Charge (USC).

Source: Department of Finance.

B: tax take in 2021, € billion



Source: Department of Finance.

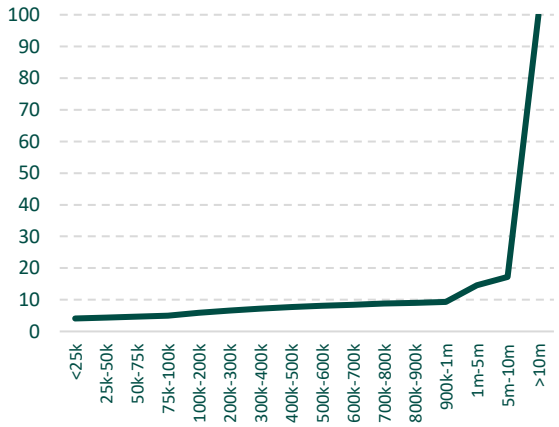
18. Corporation tax receipts amounted to €15.3 billion last year, just €100 million behind the tax take from VAT. The distribution of corporation tax is highly skewed towards firms that are more profitable (**figure 3A**). In 2019, firms with profits in excess of €1 million paid 90 per cent of corporation tax receipts.

19. In addition, there is a concentration risk from the high volume of corporation tax paid by a small number of firms and, indeed, a small number of sectors. Last year, the top ten corporation taxpayers accounted for over half of the overall corporation tax take (**figure 3B**). Sector-wise corporation tax receipts are highly concentrated in the highly profitable FDI-related sectors, such as manufacturing, ICT and finance.

20. This concentration represents significant vulnerability for the stability of taxation revenues, and, ultimately, the sustainability of the public finances. The volatile nature of this tax head has, therefore, been consistently highlighted, with repeated recommendations made against using it to support permanent public expenditure decisions.[16] This must also be considered in the context of the recent OECD Inclusive Framework agreement and its implications for taxation revenues in Ireland.

21. Figure 3: corporation tax

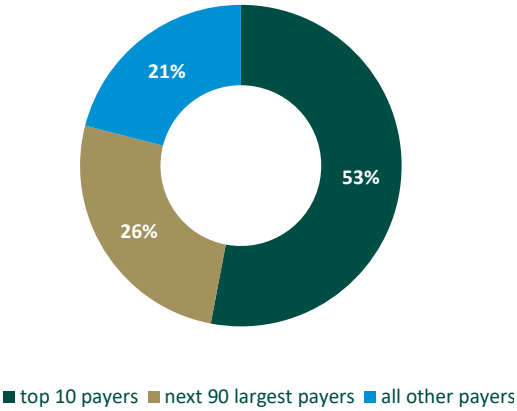
A: corporation tax paid by trading profits, per cent of total



Note: data relate to 2019 and is on a net trading profits and net receipts basis

Source: CSO, Revenue Commissioners.

B: distribution of corporate tax payments, 2021



Note: data is on a net receipts basis

Source: Revenue Commissioners.

22. There is also a risk associated with the sectoral concentration of income tax receipts. Revenue data show that employees of foreign-owned multinational firms account for about one third of all income tax in 2020.[17] A shock to the multinational sector could impact income tax along with corporate tax receipts, with significant implications for the public finances.

[16] See: https://assets.gov.ie/40629/6e8b86ab8a734c298e9f975fbf18b92c.pdf, https://assets.gov.ie/7290/750c0d5c58d840c5a811bbb557684966.pdf, https://assets.gov.ie/180895/84ddd029-9925-4464-829b-8470079f5d9a.pdf, www.gov.ie/en/publication/678e5-irelands-corporation-tax-roadmap-january-2021-update/

[17] See Revenue Commissioners (2022) *Corporation Tax – 2021 Payments and 2020 Returns, available at*: www.revenue.ie/en/corporate/documents/research/ct-analysis-2022.pdf

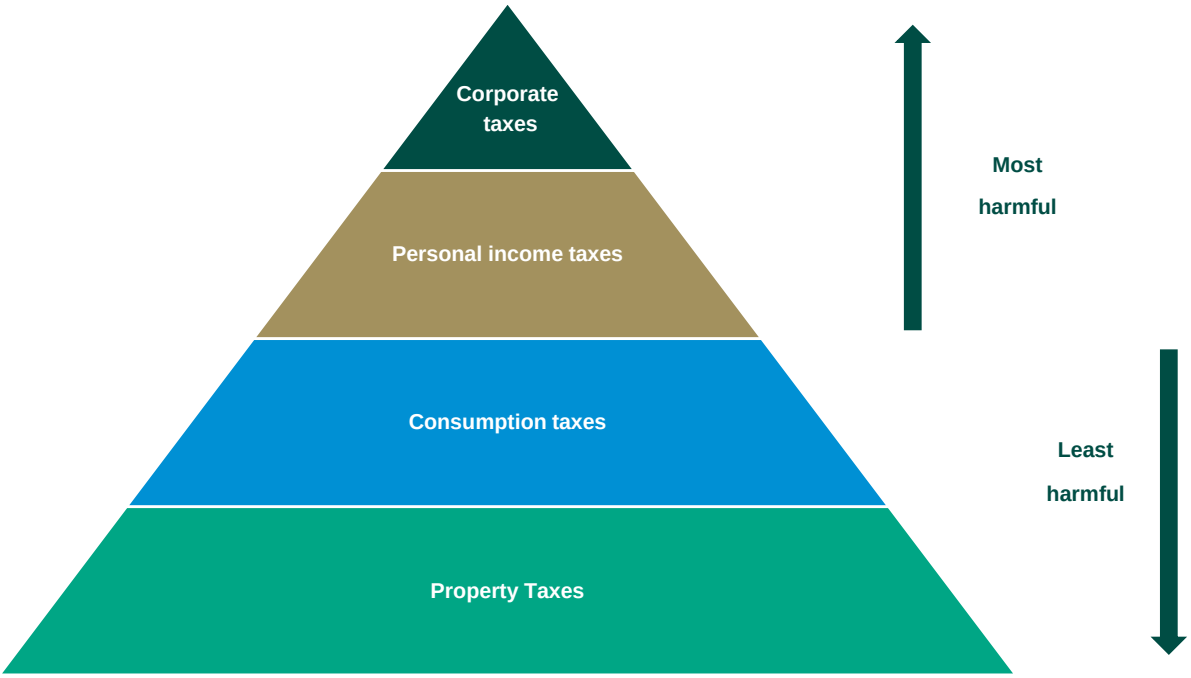
3.2 The Taxation System in an International Context

3.2.1 INTERNATIONAL ASSESSMENTS OF THE TAX BASE

23. Given its diverse roles, taxation inevitably involves trade-offs. It is not possible to raise the large sums of money that are necessary to finance the State without generating side effects. This raises the question of how best to structure a taxation system to minimise distortions, while delivering a growth-friendly economy and sustainable public finances.

24. The OECD's hierarchy of taxation (**figure 4**) provides a lens within which to consider how particular types of taxes impact economic growth. It places an emphasis on consumption taxes (blue) and recurrent taxes on immovable property (light green) as being the least growth-harmful.[18] The OECD point to the value of other growth-friendly reforms such as broadening the tax base; reducing tax rates; improving the extent to which taxes correct for externalities; and ensuring efficiency or equity justifications for tax expenditures.

Figure 4: OECD hierarchy of taxation



Source: OECD (2010), *Tax Policy Reform and Economic Growth,* OECD Tax Policy Studies No 20, OECD Publishing.[19]

[18] See also: Arnold, J. (2008) *Do Tax Structures affect Aggregate Economic Growth? Empirical Evidence from a Panel of OECD Countries,* OECD Economics Department Working Papers No. 643. Available at: https://dx.doi.org/10.1787/236001777843

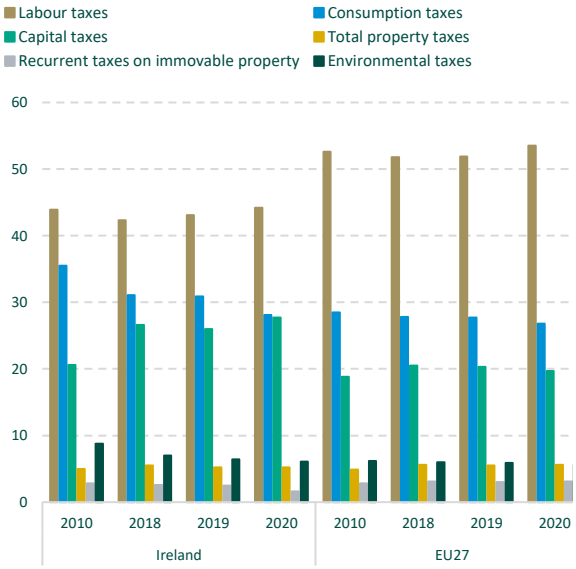
[19] Available at: http://dx.doi.org/10.1787/9789264091085-en

25. Focusing on Ireland, the OECD[20] recommend reforms to broaden the tax base, streamline the VAT system and improve the efficiency of the taxation system *inter alia* through less distortionary taxes such as recurrent taxes on immovable property. The OECD also suggest that windfall tax receipts be used to pay down general government debt and/or transferred to the Rainy Day Fund.

26. The IMF's recent 2022 Article IV Mission[21] to Ireland and the European Commission's *2022 Country Report for Ireland*[22] outline similar recommendations, given the narrow income tax base, excessive reliance on corporation taxes and uncertainty associated with changes in international corporate income tax rules, and the fiscal challenge of long-term demographic change. Emphasis is also placed on environmental taxation to support Ireland's climate action goals.

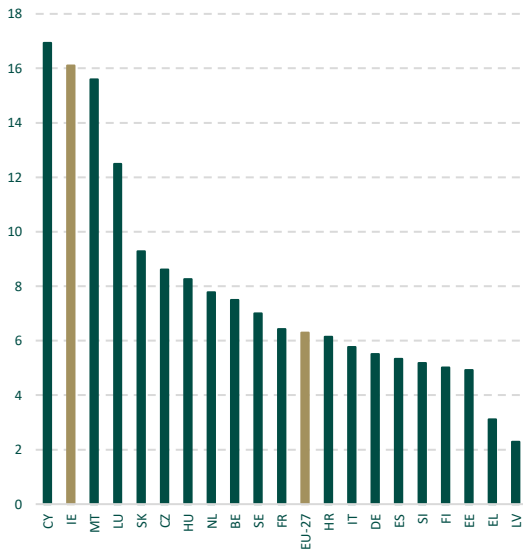
Figure 5: Irish taxation system in an international context

A: comparative indicators on taxation, per cent of total taxation



Note: data relate to 2020 and use the Eurostat definition of tax revenue (including social contributions), which is a wider definition based on national accounts/general government revenue.
Source: European Commission DG Taxation and Customs Union, based on Eurostat data.

B: corporation tax as a share of tax revenue, per cent



Note: data relate to 2020 and use the Eurostat definition of tax revenue (including social contributions), which is a wider definition based on national accounts/general government revenue.
Source: European Commission DG Taxation and Customs Union, based on Eurostat data.

[20] See Economic Survey: Ireland 2020, OECD (2020), available at: https://www.oecd-ilibrary.org/economics/oecd-economic-surveys-ireland_19990324

[21] Available at: www.imf.org/en/News/Articles/2022/05/05/mcs050522-ireland-staff-concluding-statement-of-the-2022-article-iv-mission

[22] Available at: https://ec.europa.eu/info/system/files/2022-european-semester-country-report-ireland_en.pdf

27. *OECD Revenue Statistics* show that Ireland has relied relatively less heavily on recurrent taxes on immovable property. In 2019, these taxes accounted for 2.5 per cent of total taxation in Ireland compared with an OECD average of 3.2 per cent. In 2020, they accounted for 1.6 per cent in Ireland, compared with 9.1 per cent in the UK and 11.0 per cent in the US (these countries being the two OECD countries with highest shares).[23]

28. In addition, analysis by the European institutions shows that Ireland's VAT base is amongst the narrowest in the EU, reflecting the zero per cent rate applying to various goods.[24]

4.3.2 EQUITY AND THE IRISH TAXATION SYSTEM

29. Strong equity considerations underpin the Irish taxation system, with the income tax system in particular being highly progressive. The latest OECD data show that for those on 67 per cent of the average wage, the tax wedge in Ireland is one of the lowest in the OECD, standing at about 25 per cent (**figure 6A**).[25] In contrast, for higher earners, the tax wedge in Ireland is 42.4 per cent, which is above the OECD average (**figure 6B**). [26]

[23] Available at: https://stats.oecd.org/viewhtml.aspx?datasetcode=REV&lang=en#. The OECD average for 2020 is not available at present.

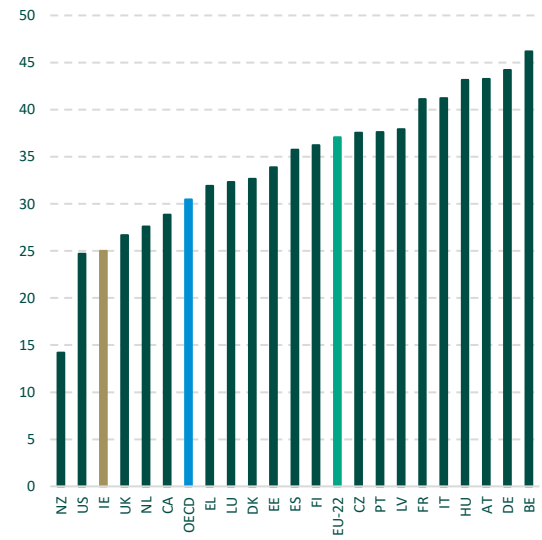
[24] See: https://ec.europa.eu/taxation_customs/system/files/2021-06/vat_rates_en.pdf and https://ec.europa.eu/taxation_customs/tedb/taxSearch.html

[25] Figures are based on a single individual without children at the average level of income. Source: OECD (2022), *Taxing Wages 2022,* available at: https://www.oecd.org/tax/taxing-wages-20725124.htm The OECD calculate the tax wedge as the sum of the total personal income tax and social security contributions paid by employees and employers, minus cash benefits received, as a proportion of the total labour costs for employers.

[26] The tax wedge measures the difference between the labour costs to the employer and the corresponding net take-home pay of the employee. Higher tax wedges an impact, employment and competitiveness, particularly given the high demand for skilled workers internationally.

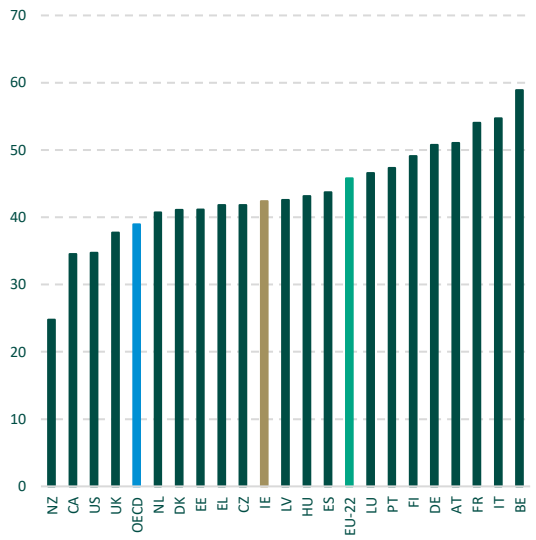
Figure 6: tax wedge, 2021

A: tax wedge at 67 per cent of average wage, 2021



Source: OECD Taxing Wages.

B: tax wedge at 167 per cent of average wage, 2021



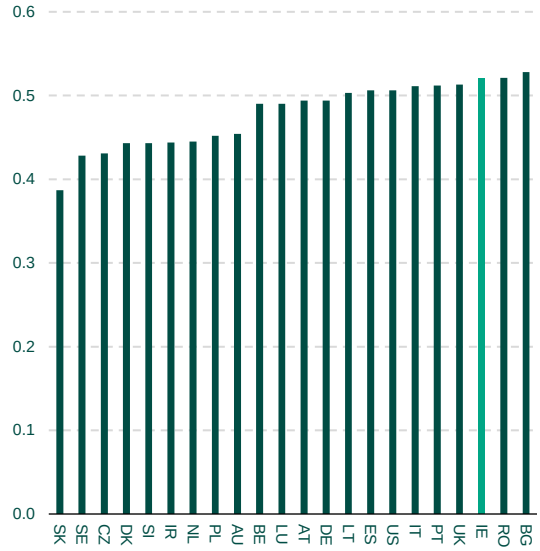
Source: OECD Taxing Wages.

30. Based on OECD data (2018), Ireland has one of the most progressive systems of taxation and social transfers across OECD countries. This data shows that Ireland recorded the third largest absolute reduction (0.23) in the Gini coefficient – the most internationally recognised measure of income inequality – between market and disposable income, after Finland and Belgium. The reduction in the Gini coefficient due to tax was the largest in the OECD each year from 2009 to 2018 (latest available).

31. National data **(figure 8B**) shows that the market Gini declines from 0.49 in SILC 2021 to 0.35 with social transfers and to 0.27 with taxes. Overall, the Gini coefficient fell to 0.27, from 0.285 the previous year.

Figure 7: income inequality

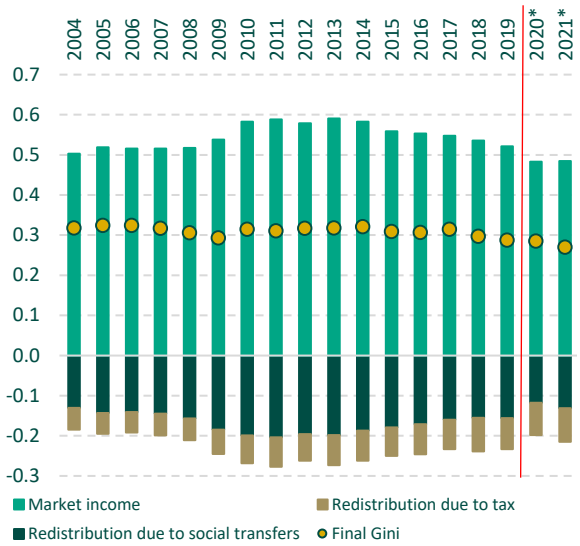
A: Gini coefficient – market income



Note: data relate to 2018 (latest available for IE)

Source: OECD income distribution database.

B: reduction in the Gini coefficient: role of tax and welfare



Note: * break in series for SILC 2020 onwards, includes changes to income definitions.

Source: CSO Survey on Income and Living Conditions.

32. Overall, the analysis shows that Ireland has a strongly progressive tax and social welfare system, though the OECD point to directly tackling market income inequality in Ireland as being a better, more economically efficient way to address the issue. In addition, analysis of the tax burden facing individuals points to a high tax wedge for higher earners.

4 Conclusion

33. This TSG paper examines the economic and fiscal context for taxation policy, including the medium-term challenges facing the taxation system and, given the current structure, how could it be best structured to enhance economic growth and provide sustainable public finances.

34. Last year, the taxation system raised over €68 billion, more than €9 billion ahead of the previous highest yield and around 2.5 times the aggregate tax return in 2000. While the taxation system has clearly evolved over the past two decades, both in terms of size and composition, some vulnerabilities remain. These risks are largely linked to the narrow income tax base and the concentration risk with corporation tax: about 500,000 income taxpayers and ten corporate taxpayers account for just over a third of total tax receipts. These risks are also interlinked – a shock to the multinational sector could impact income tax along with corporate tax receipts, with significant implications for the public finances.

35. Beyond this, the economic and fiscal context is critical, and presents challenges for taxation revenue and the tax base. Irish gross public debt remains high, approaching a quarter of a trillion euros, the equivalent of €47,500 per capita, a figure that is amongst the highest in the developed world. A different borrowing environment is on the horizon. Structural fiscal headwinds are looming, including in the form of demographic change, reform of international corporation tax, and the 'twin transitions' of climate change and digitalisation. In addition, the economy is entering a period of potentially significant structural change. Financing is also required to support ongoing public service needs.

36. It is in this context that taxation policy has an essential role to play. These economic and fiscal challenges emphasise the need for taxation policy to be responsive, alongside wider public policy actions. The international institutions – the OECD, the IMF and the European Commission – all highlight the need for reforms to broaden the tax base and to restructure the taxation system *inter alia* through less distortionary taxes. It is also crucial that tax expenditures are reviewed regularly to ensure they remain economically efficient, policy relevant and are timely, targeted and temporary in nature. Finally, in line with the OECD hierarchy of taxation, there is scope for the Irish taxation system to move towards immobile factors of production.

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