Journal of the Statistical and Social Inquiry Society of Ireland
Vol. XXVII, Part I

TAX REFORM SINCE THE COMMISSION ON TAXATION

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(read before the Society, 9 December 1993)

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1. INTRODUCTION

From an economic perspective the decade of the 1980s was characterised by world-wide tax reform. This movement can be understood when placed in the context of the widespread discontent that surrounded the prevailing tax systems[1]. Nominally progressive tax systems were widely perceived to be inefficient in their allocative role and ineffective in their redistributive role. A myriad of tax deductions, tax allowances and tax reliefs, and the advantage that could easily be taken of them, encouraged substantial tax avoidance.

Ireland, at the close of the 1970s, was no exception to this dissatisfaction. Before the 1980 budget, close to 750,000 people participated in marches advocating tax reform. This widespread disquiet was not difficult to understand. In the mid-1970s, as Figure 1 shows, tax revenue in Ireland was slightly above 30 per cent of Gross National Product (GNP) but by the mid-1980s this figure was over 43 per cent[2]. Figure 2 shows the percentage of taxpayers liable at above standard rates of tax for the period 1974 to 1993.

Although not excessive by EC or OECD standards, the composition of tax revenues in Ireland changed dramatically over the course of the 1970s as demonstrated by Table 1[3]. For example, personal income tax as a proportion of total tax revenues had increased from 18.3 per cent to 32 per cent over the ten year period.

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* The author gratefully acknowledges a research grant from the Foundation of Fiscal Studies. Written comments from an anonymous referee and many members of the Economics Department in Trinity are much appreciated. Unfortunately any remaining errors are mine.

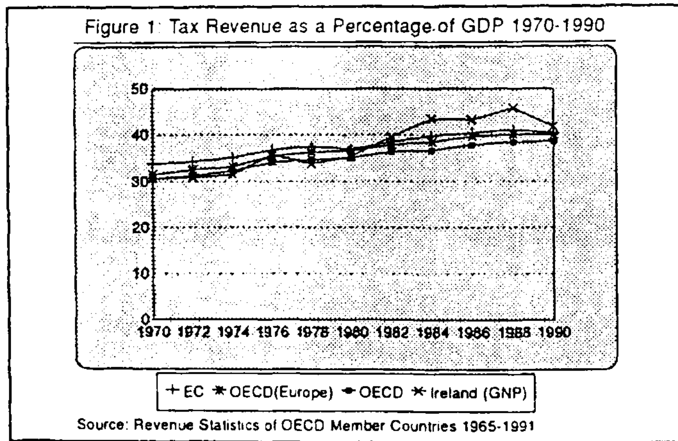


Table 1 Composition of Tax Revenue in Ireland, 1970-1990

Taxes	1970	1975	1980	1985	1986	1987	1988	1989	1990
Personal Income	18.3	25.2	32.0	31.3	32.6	34.7	34.8	31.7	31.9
Corporate Profits	8.8	4.8	4.5	3.2	3.5	3.2	3.8	3.4	5.0
Social Security	8.2	13.8	14.3	14.8	14.2	14.0	13.9	14.5	14.8
Goods & Services	52.4	46.5	43.7	44.4	44.1	42.5	42.0	44.3	42.3
(Taxes on specific commodities)	(36.4)	(29.7)	(28.3)	(22.0)	(21.5)	(20.5)	(19.7)	(21.1)	(20.1)
Property	12.2	9.7	5.3	4.0	3.8	4.4	4.0	4.8	4.7

Source: Revenue Statistics of OECD Member Countries 1965-1991, Tables 11-25.

An unsustainable trend in Irish taxation was the increasing number of taxpayers liable to tax rates that were above the standard rate. By 1983, over 40 per cent of Irish taxpayers were faced with marginal rates of 45 per cent or higher, whereas before 1975 less than 5 per cent of Irish taxpayers paid tax at above the standard rate.

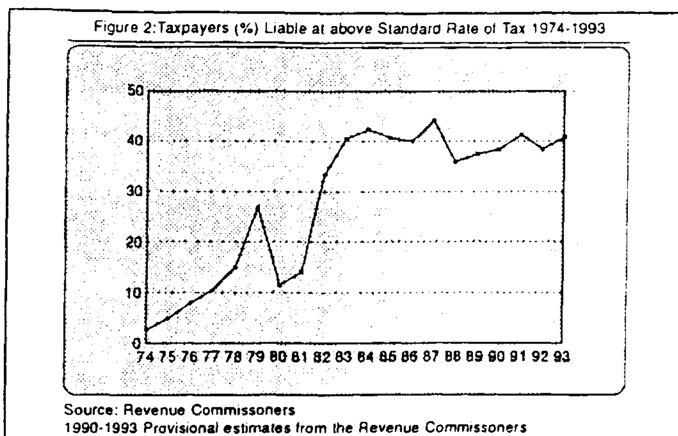


Figure 2:Taxpayers (%) Liable at above Standard Rate of Tax 1974-1993

Source: Revenue Commissoners
1990-1993 Provisional estimates from the Revenue Commissoners

The Irish tax system had little justification on efficiency or equity grounds as income tax, corporation tax, capital gains tax, capital acquisitions tax, value-added tax and excise tax all suffered from the same malaise - a small base and high rates. There was widespread agreement that the revenue from corporation tax was too low and the PAYE sector felt that they paid more than their fair share of income tax. The above problems were compounded by the lack of indexation in an environment of close to 20 per cent inflation.

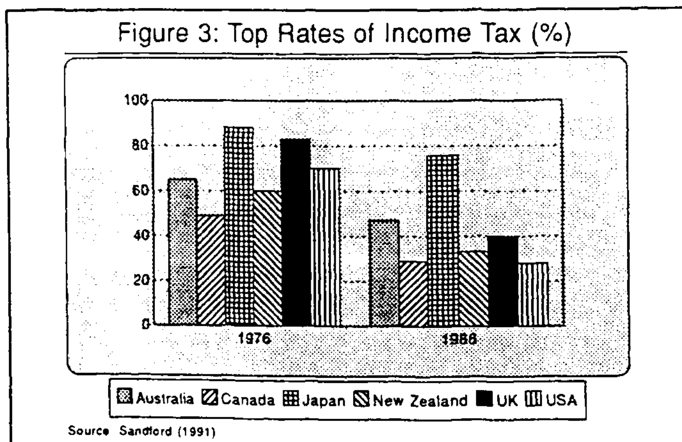
It was against this background that the Commission on Taxation was established in March 1980. The following extract, from its terms of reference, outlines succinctly its assignment;

" To enquire generally into the present system of taxation and to recommend such change as appears desirable and practicable so as to achieve an equitable incidence of taxation, due attention being paid to the need to encourage development of the national economy and to maintain an adequate revenue yield."

Over the next five years the Commission published five reports which dealt comprehensively with all issues relating to the Irish tax system: direct tax, tax incentives, indirect tax, special taxation and the administration of the tax system. A list of recommendations was accompanied by a suggested timetable for implementation. The Commission provided a comprehensive and widely acclaimed blueprint for the implementation of both an equitable and a more efficient tax system.

During the decade significant tax reform legislation was enacted in many other countries. Salient examples include the US Tax Reform Act of 1986, the UK budgets of 1984 and 1988 and the radical restructuring of New Zealand's financial

procedures and position since 1986. Although each reform package was country-specific, some general features repeated themselves across the world. Sandford (1991) identifies three underlying trends: a decrease in the highest rates of income tax, a movement towards a broader income base combined with lower tax rates and a shift away from the direct taxation of income. Some idea of the magnitude of the decrease in the highest rates of income tax is captured by Figure 3[4].



The highest income tax rates across the OECD fell on average from 54 per cent to 44 per cent in the period from 1985 to 1988 (Bird & Cnossen (1990)). The marginal rates of income tax facing the majority of taxpayers also fell, but not as dramatically and in many countries the actual number of tax rates fell considerably. Table 2 and Figures 3 & 4 taken together bear witness to the subsequent movement towards a flat-rate income tax.

Table 2 Initial Rates of Income Tax, 1975 and 1989

Country	1975	1989
Australia	20%	24%
Canada	9%	17%
Japan	10%	10%
New Zealand	19%	24%
United Kingdom	35%	25%
United States	14%	15%

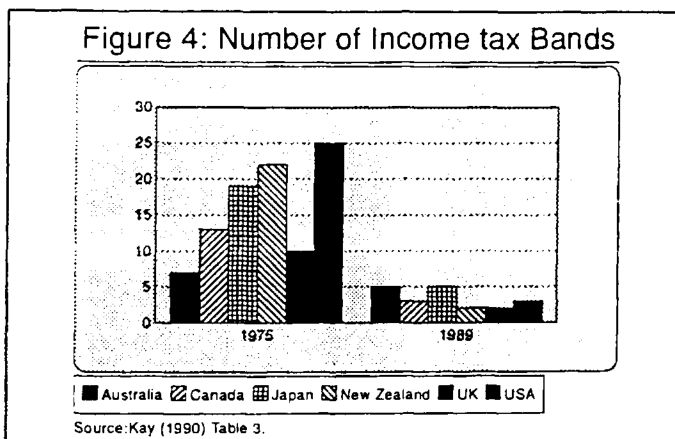


Figure 4: Number of Income tax Bands

Source:Kay (1990) Table 3.

To offset the lower tax revenue to be expected from lower tax rates there was a movement towards a broader definition of the income tax base. In line with the principles of Equitable Taxation (ET), income from a variety of sources is now subject to tax at rates closer to the rate imposed on labour income - the source of income has become somewhat less important. Capital gains (e.g. Australia, Canada, Sweden and US), fringe benefits (e.g. Australia, Finland, New Zealand, Sweden and UK) and dividend income (e.g. Australia and New Zealand) have been at least partially incorporated into the effective definition of income, the inclusion of dividend income being facilitated by a general movement towards the imputation system of corporate taxation.

Finally, Sandford notes that some countries have witnessed a shift away from the 'direct' taxation of income and towards 'indirect' taxation, e.g. a value-added tax or a general sales tax (e.g. Canada, Greece, Iceland, Japan, New Zealand, Portugal, Spain and Turkey). At first glance it appears that Table 3 demonstrates that the overall tax mix in the industrialised countries has seen little change. However, although the *broadening* of the income tax base has to a large extent offset the *lowering* of the tax rates, there has been significant movement away from specific or excise taxes and towards a general tax on consumption.

Ironically Ireland, which had an internationally acclaimed tax reform package, is generally argued to have lagged behind the rest of the world in regard to tax reform. The rest of this paper attempts to assess the progress made in implementing the recommendations of the Commission on Taxation. It is hoped to draw out the links between the actual tax changes implemented by Irish governments and the Commission's radical reform proposals.

Table 3 Composition of Tax Revenue in EC, OECD(Europe) & OECD, 1970-90

Taxes	1970	1975	1980	1985	1986	1987	1988	1989	1990
Personal Income									
EC	22.2	26.1	27.5	26.3	26.1	26.3	26.5	25.2	25.9
OECD(EUROPE)	26.2	29.1	30.1	27.9	28.0	27.8	28.2	27.3	27.9
OECD	27.9	30.9	32.4	30.6	30.7	30.2	30.5	29.5	30.1
Corporate Profits									
EC	7.4	6.5	6.6	7.3	7.4	7.4	7.3	7.4	7.6
OECD(Europe)	6.4	5.7	6.0	7.0	7.1	6.6	6.6	6.6	6.8
OECD	8.7	7.3	7.5	7.9	7.8	7.7	7.8	7.8	7.7
Social Security									
EC	26.3	30.4	29.7	29.7	29.1	29.2	28.9	28.7	28.4
OECD(Europe)	21.9	25.6	26.0	25.8	25.6	25.8	25.7	25.9	25.8
OECD	19.4	22.9	23.3	23.5	23.3	23.4	23.3	23.4	23.5
Goods and Services									
EC	36.7	31.5	31.1	31.6	32.9	32.6	32.5	32.0	31.9
OECD(Europe)	38.3	33.3	32.1	33.0	33.4	33.6	33.1	32.5	32.1
OECD	35.8	31.4	30.3	31.1	31.1	31.6	31.2	30.7	30.3
(Specific Taxes)									
EC	19.2	14.8	14.1	13.6	13.5	13.1	12.9	12.4	12.2
OECD(Europe)	21.4	16.8	15.1	13.9	13.8	13.1	12.4	12.1	11.9
OECD	20.4	16.2	14.8	13.7	13.5	13.0	12.2	11.7	11.4
Property									
EC	6.5	5.6	4.6	4.1	4.3	4.6	4.5	4.7	4.6
OECD(Europe)	5.9	5.0	4.3	4.1	4.3	4.6	4.5	4.7	4.5
OECD	7.0	6.0	5.2	5.1	5.3	5.6	5.5	5.6	5.5

Source: Revenue Statistics of OECD Member Countries 1965-1991, Tables 11-25.

The next section outlines the theoretical framework behind the Commission's recommendations for the Irish tax system. Section 3 details actual changes enacted to the tax system since 1982, and attempts to measure their effectiveness in terms of the Commission's recommendations. It will be seen that steady, but somewhat slow, progress has been made in implementing some of the Commission's major proposals in spirit, if not in letter. We argue that in some cases inflation has saved the government the task of explicitly removing, or reducing, politically sensitive allowances/deductions. Conversely, the lack of indexation in the personal tax system

has led to almost relentless 'bracket-creep' over the last ten years and is the most serious indictment on the government's failure to implement the Commission's recommendations. It will also be argued that the forces of tax harmonisation/competition, rather than planned tax changes, lie behind recent, and expected future, movements in the Irish direct, and indirect, tax systems.

Given that the Commission's first report was published over ten years ago and is still awaiting substantial implementation, Section 4 will focus on the question of the optimal speed of implementation and will argue that although some progress may have been made in selected areas at the optimal pace, recent changes made to the tax system suggest that vested interests have derailed the 'gradualist' approach to tax reform and argues in favour of the 'big-bang' approach to tax reform in an Irish context. Some comments on the past and future direction of tax reform in Ireland conclude the paper.

2. THE COMMISSION'S RECOMMENDATIONS

Economists judge the merits of a tax system in the light of three interdependent criteria: efficiency, equity and administrative simplicity. In the realm of taxation, efficiency implies that the government should collect the desired amount of revenue with the minimum possible disturbance to the market-place. Barring the existence of lump-sum taxes, all taxes will place a margin between the buying price and the selling price of a product or factor. As a result of this tax wedge, market signals about demand and supply cannot be optimal and resource miss-allocation must follow. Efficiency requires the *minimisation* of this margin and the ensuing distortion, given the amount of revenue which must be collected to finance government spending[5].

There are two dimensions to the concept of equity in economics; horizontal and vertical. Horizontal equity concerns the treatment of people in similar circumstances. The fundamental principle of horizontal equity requires that people in similar positions be treated similarly. In the context of taxation policy, horizontal equity implies that two people who were equally 'happy' before-tax, should be equally 'happy' after-tax. Given the difficulty of measuring utility and the impossibility of interpersonal comparisons, practical implementation of this principle would suggest that people on equal pre-tax incomes should be taxed equally.

Vertical equity focuses on the treatment of dissimilar individuals, i.e. how people on different levels of pre-tax income are taxed. The fundamental intricacy underlying the issue of vertical equity is the optimal progressiveness of the tax system. To focus accurately on vertical issues requires significant consideration to be given to the expenditure side of the budget as it is argued that the overall level of progressivity in

the tax-transfer system stems predominately from the latter. It is claimed that the progressive income tax is almost completely offset by regressive expenditure taxes[6].

The goal of administrative simplicity is self-explanatory but must encompass the task, not only of collecting and paying taxes, but also of enforcing the tax code. In the literature on the design of a tax system, two major approaches can be isolated: Equitable Taxation (ET) and Optimal Taxation (OT). ET focuses on the requirement of horizontal equity whilst OT focuses on the requirements of economic efficiency and vertical equity and in particular to the trade-off between these two goals. To see the non-equivalence of these two approaches, and to understand the trade-off between the two concepts of equity and efficiency inherent in any tax system, a simple example should suffice. Empirical work in labour supply invariably shows that labour supply elasticities are lower for men than women. To followers of the objectives of ET this is irrelevant, equally well-off men and women must be treated equally. To OT enthusiasts, however, an obvious policy prescription follows - tax men at a higher marginal rate than women to minimise the associated efficiency costs.

The pursuit of horizontal equity under ET entails some efficiency costs, at least in a static framework, as mobile factors of production are taxed at the same rate as immobile factors of production. This also places an upper limit on the feasible rate of tax. On the benefit side must be incorporated the ease of administrating a more neutral tax system and the decreased likelihood of there being wasteful 'rent-seeking' (see later) in a tax system founded on the principles of ET. As a consequence of these advantages it is not surprising that ET is favoured by many tax practitioners. Heady (1993) assesses the contributions of OT to actual tax policy. As an approach to the design of the optimal tax system it has in the past been dismissed rather lightly. Given the increasing mobility of goods, services, capital and factors of production however, it is likely that the efficiency gains from a tax system that incorporates at least some of the principles of the OT literature will become more apparent.

A fundamentally different approach to the design of tax systems, developed by Downs (1957), Buchanan and economists from the 'public choice' perspective, is to focus on the amount of tax revenue to be raised and to treat it as a variable to be determined within the political process[7]. If one follows their view of the objectives of the state bureaucracy, the aim at a constitutional stage should be to make it difficult for 'Leviathan' to finance its invariably excessive budget. In the above example, the policy prescription might be to allow the government to tax only the elastic tax base, i.e. women. In general, high tax rates and loopholes in the tax system could be seen as highly efficient, rather than inefficient, when viewed from this approach.

The Commission, by design, and we would suggest by choice, followed the doctrine of ET closely. The terms of reference of the Commission refer explicitly to the *"equitable incidence of taxation"*, and whilst this does not demand adherence to the ET line to the complete exclusion of OT, it is clear from the reports that the Commission leaned heavily in its direction. The Commission only strayed from this line when trying to incorporate elements of vertical equity and administrative simplicity into a system designed with horizontal equity paramount. In the context of the Irish tax system at that time the Commission faced the possibility of increasing both efficiency and equity in many cases, so implying no conflict between the goals of ET and OT[8].

The implementation of any tax system, but in particular one based on the principles of ET, must be facilitated by a measuring rod of utility or ability-to-pay. The Commission chose the Schanz-Haig-Simon definition of comprehensive income as the appropriate measure of income. Under this criterion the appropriate measure of income in a given period is the amount of expenditure possible whilst leaving an individual's net wealth intact. Income in this sense would include labour income, dividend income, interest income, fringe benefits, gifts and inheritances, capital gains, pensions, gambling winnings, social welfare payments..., in fact any increase in net wealth, independent of its source, would constitute an addition to this tax base[9]. Imputed income from home-ownership and ideally the imputed utility from leisure should also be included. The category of the actual income-earner is of no relevance, e.g. self-employed, employee, farmer or unemployed. The family was to be regarded as the relevant unit for tax purposes.

The Commission recommended that this comprehensive income base be taxed at a single rate. This rate should be set at a level that would allow income tax to remain the major source of government revenue. A rate lower than the then standard rate of 35 per cent was envisaged and the corresponding reduction in tax revenue would be financed by the above mentioned widening of the definition of income and elimination of tax expenditures (allowances, reliefs and deductions), apart from a personal tax credit, a married person's tax credit and a head of household tax credit[10]. The Commission's view of tax expenditures in general was clear, the tax system should not be used to achieve every allocative and distributive goal of the government, no matter how honourable. Targeting with direct payments was regarded as more equitable and efficient in most cases.

The Commission advocated the abolition of pay-related social insurance (PRSI) contributions and other assigned revenues, to be replaced by a flat rate social security tax (approximately 5 per cent) to be levied on all income. The employer's contribution would be based on profits as opposed to payroll. To facilitate the desired level of income redistribution, the Commission encouraged the introduction of a direct expenditure tax on the highest income earners. A direct expenditure tax is levied on the individual unit's expenditure as opposed to income and as such

encourages savings. Taxpayers are not required to retain all their receipts from expenditures, merely to record their total income for the period in question and their non-consumption outgoings (e.g. savings, donation to charities); the difference being their taxable expenditure. The Commission envisaged that this tax would only apply to the top decile of income-earners. The particular rate(s) to be chosen should not be excessive as this would not be justifiable on efficiency or equity grounds.

The Commission recommended a restructuring of the tax treatment of borrowing and saving to facilitate a levelling of the playing-field. The Commission focused on the discrimination between the different modes of savings inherent in the Irish tax system. The tax treatment of deposits, including national savings, should be similar across all deposit-taking institutions. To discourage the use of housing as an investment good, mortgage interest tax relief (MITR) should be replaced by a system more directly focused on first-time buyers. After the (re-)introduction of a property tax, however, full deductibility of real mortgage interest should be allowed. Income tax relief on assurance premiums should be discontinued[11]. Since a perceived feature of a comprehensive income tax is its detrimental effect on saving, the Commission suggested the establishment of individual retirement accounts (IRAs) along US lines to offset this.

Corporation tax was to be set at the standard rate of income tax and full imputation allowed, implying that the tax system would not influence the organisational form of business activity. The introduction of an advance corporation tax (ACT) was also envisaged. The Commission in its second report suggested that the perceived need for tax incentives stemmed from the environment of high marginal rates of taxation and recommended a tax allowance for true economic depreciation only and the replacement of tax expenditures with direct aid for attracting foreign investment, encouragement of market and product development and the short-term protection of 'infant' industries in the traded sector. Debt servicing was not to be allowable against profits implying that the corporate tax system would not interfere in the choice between equity and debt[12].

With respect to 'indirect' taxation, the Commission recommended a single rate of value-added tax on all final purchases[13], again emphasising one of the central themes of the Commission's reports, namely that redistributive goals are best achieved directly[14]. Given a comprehensive base, a rate of 15 per cent was estimated to be revenue neutral, significantly less than the then standard rate of 23 per cent. Continued use of excise taxes on alcohol, tobacco, motoring and betting[15] would be justified along the standard negative externalities grounds, but in setting indirect tax rates, due attention was to be paid to the problem of cross-border trade. The abolition of stamp duties, including the bank and insurance levies was recommended.

The fourth report dealt with issues of special taxation including local taxation and the tax treatment of property, natural resources and charities. Major recommendations included a property tax, preferably local, to be offset by the abolition of the residential property tax and a general reduction in taxes, and the possible introduction of an environmental tax which was not to be used for revenue enhancing purposes. Local service charges were to be implemented where feasible. Economic rent accruing from the exploitation of Irish natural resources should be taxed to the greatest possible extent consistent with the development of the resources.

The final report dealt with tax administration and recommended a move towards widespread self-assessment to allow/force the taxpayer to take more responsibility for his, or her, financial affairs, the retention of the cumulative system of PAYE, the deduction of tax at source where possible and the granting of extra powers to the Revenue Commissioners in the enforcement of the tax code. The Commission argued persuasively in this, their final, report that increased compliance with the tax code in terms of less tax evasion and tax avoidance would follow on naturally from the significant simplifications to the overall tax system recommended in earlier reports.

The Commission recognised the distorting influence of inflation on the tax system and argued that the tax system should be indexed in line with inflation so as to avoid bracket-creep[16]. The Commission strenuously argued for the adoption of its five reports as an integral package of tax reforms and against selective implementation which would invariably be based on political considerations. As regards the actual timing of implementation, the Commission foresaw the widening of the tax bases/lowering of the tax rates combined with moves towards the introduction of a single rate of VAT, via a two-rate structure, as occurring in the immediate future[17]. A local property tax could be implemented via self-assessment with minimal delay and its recommendations on tax incentives would be implemented over a transitional period allowing the natural expiration of existing incentives. The Commission suggested a time scale of at least three-four years for full implementation of their tax package.

3. TAX REFORM IN IRELAND 1982-1992

It is over ten years since the publication of the Commission's report on direct taxation. In 1982/83, five tax bands operated (six in 1983/84) but since that date there has been a steady decline in the number of bands as well as in the actual rates as can be seen in Table 4.

Table 4 Personal Income tax rates in Ireland

1982/83	1987/88	1992/93	1993/94
£1,000 @ 25%	£4,700 @ 27%	£7,475 @ 27%	£7,675 @ 27%
£2,000 @ 35%	£2,800 @ 48%	Bal. @ 48%	Bal. @ 48%
£2,000 @ 45%	Bal. @ 58%		
£2,000 @ 55%			
Bal. @ 60%			

Aside from the non-implementation of a direct expenditure tax, it is obvious that the nominal changes in the structure of the direct personal tax system are very much in the spirit of the Commission's recommendations. Administrative simplicity is facilitated by the existence of only two rates and the required degree of vertical equity is achievable via the higher rate.

As regards employee PRSI contributions and other assigned revenues there has been little radical movement since 1982. The ceiling on the health contribution has been abolished (1991) and the ceiling on PRSI contributions has doubled in nominal terms over the ten years (a real increase of 20 per cent). The 1993 Budget, however, witnessed the introduction of a new 'temporary' income levy of 1 per cent for those earning above £9,000.

Table 5 Assigned Revenue rates in Ireland

Category	1982/83	1992/93	1993/94
Employment rate	1.0%	1.0%	1.0%
Employment ceiling	None	None	None
Health rate	1.0%	1.0%	1.0%
Health ceiling	£9,500	None	None
PRSI rate	5.5%	5.5%	5.5%
PRSI ceiling	£9,500	£19,000	£20,000
Income rate	-	-	1%
Income floor	-	-	£9,000

Following the general thrust of the Commission's recommendations the PRSI allowance has actually fallen in nominal terms (a real decrease of 68 per cent) and the PAYE allowance has fallen in real terms by 27 per cent. The exemption limit remains constant in real terms which is consistent with keeping the poor from the tax net but suffers from the disadvantage of imposing a high marginal tax rate on low levels of income ('poverty-trap').

Table 7b Effective tax rates for married couples*

Income as a percentage of average industrial wage	Effective rates of income tax (including assigned revenues)			
	1982/83	1987/88	1992/93	1993/94
50%	7.5	7.75	7.75	7.75
60%	7.5	13.9	11.3	11.4
80%	11.5	21.1	20.6	21.6
100%	**19.3**	**25.4**	**23.4**	**24.5**
150%	26.7	31.9	27.2	28.2
200%	30.1	36.3	32.0	33.0
400%	43.3	47.6	41.1	42.0
500%	46.8	49.9	42.9	44.0

(The exemption limit, personal, PAYE and PRSI allowances are incorporated).
** One spouse working*

Although the above tables do not detail the movement in effective rates within the ten year period, they do demonstrate that over the ten years the beneficiaries of income tax reform have not been the below-average income-earners[18]. They also indicate a worsening of this situation in the current year. While a common complaint is the speed at which one reaches the top rate of tax, perhaps a greater concern should be the speed at which one reaches the standard (and initial) rate of tax and the magnitude of that rate in Ireland[19].

We can repeat the above exercise to see how marginal tax rates have changed in real terms over the last 10 years.

Table 6 Standard Income tax allowances/exemptions in Ireland

Tax provision	1982/83	1987/88	1993/94	Real change (82-93)
Personal allowance	£1,450	£2,000	£2,170	-10%
PAYE allowance	£600	£700	£800	-27%
PRSI allowance	£312	£286	£286	-68%
Exemption limit	£2,379	£2,650	£3,600	-9%

The non-indexation of the tax bands and personal allowances has had consequences for the effective (average) and marginal tax rates confronting all taxpayers. To compare effective, and marginal, tax rates on different levels of income, an allowance for the growth in real incomes must be made. Comparisons over time are made with respect to the average earnings of industrial workers in manufacturing, £6,600 in 1982, £10,070 in 1987, £12,600 in 1992 and approximately £13,000 for 1993. Tansey (1991) notes that some surveys suggest that the average industrial wage may be an underestimate of the average wage of all non-agricultural employees but Hills (1988 p.9) makes the point that 61 per cent of men, and 70 per cent of all adult full-time workers in Britain, earned less than the average wage in 1987.

Table 7a Effective tax rates for single people

Income as a percentage of average industrial wage	Effective rates of income tax (including assigned revenues)			
	1982/83	1987/88	1992/93	1993/94
50%	14.6	22.0	21.1	21.2
60%	19.1	25.4	23.4	23.5
80%	24.9	30.4	26.2	27.3
100%	**28.8**	**35.4**	**31.2**	**32.3**
150%	38.0	45.3	39.4	40.5
200%	43.6	48.8	42.2	43.3
400%	52.3	53.9	46.2	47.3
500%	54.0	54.9	47.0	48.1

(The exemption limit, personal, PAYE and PRSI allowances are incorporated.)

Table 8a Marginal tax rates for single people

Income as a percentage of average industrial wage	Marginal rates of income tax (including assigned revenues)			
	1982/83	1987/88	1992/93	1993/94
50%	32.50	42.75	34.75	34.75
60%	42.50	42.75	34.75	34.75
80%	42.50	55.75	34.75	35.75
100%	**52.50**	**55.75**	**55.75**	**56.75**
150%	56.00	64.50	55.75	56.75
200%	61.00	59.00	50.25	51.25
400%	61.00	59.00	50.25	51.25
500%	61.00	59.00	50.25	51.25

(The exemption limit, personal, PAYE and PRSI allowances are incorporated.)

As the efficiency losses associated with taxation increase with the <u>marginal</u> tax rate it is clear that the income tax system has become less efficient in many cases[20]. The average industrial wage earner is faced with higher effective and marginal tax rates, even after the large increase in the standard tax band announced in the 1992 budget. It is clear that whilst changes in the structure of income tax are encouraging at first glance (Table 3), inflation has exacerbated the problems that led to the Irish 'tax-revolt' of 1980.

Table 8b Marginal tax rates for married couples*

Income as a percentage of average industrial wage	Marginal rates of income tax (including assigned revenues)			
	1982/83	1987/88	1992/93	1993/94
50%	7.50	7.75	7.75	7.75
60%	7.50	42.75	55.75**	55.75**
80%	32.50	42.75	34.75	35.75
100%	**32.50**	**42.75**	**34.75**	**35.75**
150%	36.00	54.50	34.75	35.75
200%	46.00	59.00	50.25	51.25
400%	61.00	59.00	50.25	51.25
500%	61.00	59.00	50.25	51.25

(The exemption limit, personal, PAYE and PRSI allowances are incorporated.)
* *One spouse working.* ** *Marginal Relief.*

To a significant extent the Irish tax system discourages working when viewed from the supply-side of the market as allowances and tax bands have not been indexed. Tansey also documents the widening 'tax-wedge' between what a employer pays and what an employee actually receives over a similar period and shows that the tax system discourages employment even more dramatically when employer's PRSI contributions are taken into account. This rate has increased from 11.61 per cent of gross employee income below £9,500 in 1982/83 to 12.2 per cent of gross employee income below £21,000 (this ceiling has increased by 64 per cent in real terms) in 1993/94.

As regards corporation tax, NESC (1986,1990) and the Report of the Industrial Policy Review Group (1992) acclaim some of the changes implemented since the Commission's reports. The introduction of Advance Corporation Tax (ACT), the elimination of accelerated depreciation allowances (1992), the ending of export sales relief, the decline in the significance of Section 84 loans, the elimination of stock relief, the introduction of self-assessment, the tax amnesty of 1988, the increase in the powers of attachment, the reduction in the number of corporate tax rates and the lowering of the tax rate (from 50 per cent in 1982 to 40 per cent by 1991) are all suggestive of an overall policy consistent with the Commission's proposals, i.e. base broadening and rate reductions. Revenue from corporation tax, partly in response to the above changes, more than doubled between 1987 and 1991 (Report of the Industrial Policy Review Group p.37). The effective tax rate on distributed profits has fallen during this period but this fall has only matched the fall in income tax rates.

Table 9 Rates of tax on distributed profits

Period	Nominal Rates of income tax	Actual Rates on distributed profits
1982/83	35%	54%
	60%	71%
1993/94	27%	42%
	48%	58%

Any further moves towards greater imputation, as recommended by the Commission, will probably have to await European Community decisions on the harmonisation of corporation tax[21].

These improvements in the structure of corporation tax, however, must be placed in the context of some base narrowing and other distortions that have been introduced since 1982; the preferential treatment of the International Financial Services Centre (IFSC), the levy on non-life insurers, the elimination of the cap on individual investors in the Business Expansion Scheme (BES), the possibility that the future allocation of pension funds will depend on the 'advice' of the government, the existence of incentives for investment in R&D and the extension of urban renewal incentives[22]. In the case of the latter two it could be argued that tax 'breaks' are the correct governmental responses to market failures but the scope of these allowances seems to be determined by lobbying/rent-seeking and short-termism as opposed to a considered analysis. The uncertain scope of the 10 per cent tax on manufacturing income has had predictable consequences - time spent on redefining, rather than operating, a business. The government must recognise the attractiveness of rent seeking in the Irish business environment.

"A pound in tax saved is worth as much to the company as a pound earned by productive activity." (Kay & King p.163)

Some of the major recommendations of the Commission's reports surrounded the inequitable tax treatment of income derived from different sources, i.e. horizontal equity across assets as well as people. Some movements have been made in the direction of their proposals;

- Employees are now taxed, on 30 per cent of the market value of company cars, and on a proportion of the benefit derived from the provision of preferential

loans. The tax relief limit from shares allocated under profit-sharing schemes and share options has been reduced from £5,000 to £2,000.

- Capital gains are now taxed (self-assessed since 1991) at a flat rate of 40 per cent, and the exemption has been halved in nominal terms over the last 10 years (in real terms it is worth only 30 per cent of its 1982 value).

- The structure of Capital Acquisitions Tax (CAT) was simplified considerably in 1984. Recent changes involve the elimination of the 45 per cent and 55 per cent bands in 1991. Inflation has also eroded the real value of the exemption limits. Although the thresholds were indexed in 1990, their real value had fallen by 30 per cent since 1984.

Table 10 Capital Acquisitions Tax threshold limits

Class	1984	1993
(a) Child, or minor child of a deceased child of the disponer.	£150,000	£171,750
(b) Sibling, lineal ancestor or descendant, niece or nephew of disponer.	£20,000	£22,900
(c) Other.	£10,000	£11,450

A probate tax of 2 per cent on estates valued above £10,000, excluding the transfer of the family home between spouses, has been introduced (1993). This tax does not apply to gifts and can only be viewed as an inefficient and inequitable way of widening the capital tax base. In the context of the Commission's reports it would be viewed as a move away from a comprehensive definition of income which focuses attention on the ex-post income of the recipient as opposed to the value of the transaction.

- Similar tax treatment applies to deposit-taking institutions via the deposit interest retention tax (DIRT). This tax is a withholding tax at the standard rate, combined with self-assessment for taxpayers on a higher marginal tax rate. Due to the potential for capital flight at the end of '1992', this rate was lowered to 10 per cent and made available to all taxpayers (with certain restrictions on access to the funds). Special Investment Accounts have been introduced to allow the insurance companies, unit trusts and stockbrokers to 'level the playing-field'.

Hills (1984) developed the concept of fiscal privilege to measure the level of the distortion caused by the non-uniform tax treatment of alternative forms of savings. It is defined as the difference between a taxpayer's marginal income tax rate and the average rate of tax imposed on the asset's pre-tax real return. The higher the degree of fiscal privilege associated with a particular asset the greater the incentive to invest in that asset. Thom (1988,1992) has applied this methodology to Ireland and Tables 11 and 12 document the 'unevenness' of the playing-field confronting standard rate, and higher rate, taxpayers respectively.

Table 11 Degree of Fiscal Privilege - Standard Rate Taxpayers.

	1979-86	1993
Deposits - Banks	-145.2%	-20%/+10%*
- Building Societies	-93.5%	-20%/+10%*
10 Yr Gilts - 3% Coupons	-54.9%	-1%
- 6% Coupons	-100.1%	-16%
Shares	-27.6%	-15%
Pension Funds - 10 Yrs	51.6%	34%
- 20 Yrs	38.7%	NA
Assurance Policies - 10 Yr	-17.2%	NA
- 20 Yr	-27.6%	NA
Inflation	11.4%	3%

*Source: Thom (1988) Table 3.1, Thom (1992) Table 1. * 10% Deposit Interest Retention Tax.*

The Commission on Taxation recommended that, aside from Individual Retirement Accounts, savings should be neither actively encouraged nor discouraged. Tables 11 and 12 demonstrate that there has been a significant reduction in the degree of the tax distortion in the savings market but this, it should be noted, stems predominantly from a decrease in the distortion caused by inflation.

Table 12 Degree of Fiscal Privilege - Higher Rate Taxpayers

	1979-86	1993
Deposits - Banks	-252.4%	-36%/+31%*
- Building Societies	-167.3%	-36%/+31%*
10 Yr Gilts - 3% Coupons	-103.4%	-2%
- 6% Coupons	-174.0%	-29%
Shares	-18.5%	-3%
Pension Funds - 10 Yrs	109.5%	71%
- 20 Yrs	80.0%	NA
Assurance Policies - 10 Yr	13.9%	NA
- 20 Yr	8.6%	NA
Inflation	11.4%	3%

Source: Thom (1988) Table 3.2, Thom (1992) Table 1. * *10% Deposit Interest Retention Tax.*

The government has made some moves towards removing some horizontal inequities across income recipients in the tax code. There has been a movement towards current year assessment for the self-employed and the tax amnesty of 1988 introduced many into the tax net. Disability pensions have been integrated into the tax system (1993). The introduction of legislation dealing with the taxation of short-term social welfare benefits is (still) expected shortly.

The value to the individual taxpayer of allowances, deductions and reliefs has been reduced in absolute and real terms over the past ten years. After years of gradual reduction the relief on life assurance has been terminated and children's allowance has been replaced by an increased tax-free direct payment. The ceiling on mortgage interest tax relief (MITR) for a single person has been reduced from £2,400 in 1982/83 to £1,900 in 1993/94, a fall of 20 per cent in nominal terms. More importantly in real terms the maximum amount of MITR is worth only 50 per cent of its 1982 value and the Minister for Finance has suggested that at some future date (after the standard tax band extends to £30,000 for a married couple) this relief will only be available at the standard rate of income tax[23].

Table 13 however, looks at the cost of allowances, or tax expenditures, to the state, rather than the value of such allowances to the individual, bearing in mind that tax forgone must be collected elsewhere. The concept of tax expenditure was developed by Surrey (1973) as an attempt to measure the cost of not obtaining a comprehensive income base. As such it can measure the progress made in implementing the key recommendation of the Commission on Taxation, namely the

adoption of the Schanz-Haig-Simon definition of comprehensive income as the appropriate base for tax purposes. The table includes only some of the allowances, reliefs or deductions that the Commission specifically referred to as inefficient and inequitable tax expenditures.

Table 13 Tax expenditures

Tax relief provision	Tax expenditure (£m)		
	1982/83	1992/93	% Real Change
Medical insurance premium	10.0	53.0	370
Pension income	40.0	141.0 ('91)	192
Loan interest	75.0	188.8	92
Interest on savings bonds	2.6	19.5 ('92)	590
Redundancy payments	5.5	7.5 ('91/'92)	-24
Compensation for loss of office	2.0	7.5 ('91/'92)	215
Artists' income	.6	1.2	40
Manufacturing relief	40.0	296.9 ('91)	582
Covenants and Maintenance Payments	2.0	29.1	1295

Sources: Income tax and corporation tax. Cost of allowances and reliefs 1982/83 & 1988/89. Statistical Report of the Revenue Commissioners - 1984 & 1991 and Revenue Commissioners.

(Please note that all 1992/93 figures are provisional estimates.)

Although the government has withdrawn some of the reliefs available ten years ago and the net value to the recipient of other reliefs have fallen considerably it is obvious that the availability of any reliefs will attract economic agents, albeit from some other economic activity[24]. Recent additions to the list of tax expenditures include: BES (£31.3m), Urban Renewal (£25.1m) and Section 27 reliefs on rented residential accommodation (£8.9m). Callan (1991) estimates the tax revenue forgone by the non-taxation of imputed income from owner-occupation. Based on 1987 tax rates and property values a tax revenue loss of £400m is derived. In terms of the comprehensive income base this figure would be an over-estimation because an allowance for real mortgage interest relief would have to be made if income from owner-occupation was to be taxed. While honourable intentions lie behind all of these discretionary reliefs, the Commission's reports were explicit about their undesirability on both equity and efficiency grounds.

There has been much movement in the structure of value-added-tax (VAT) since the publication of the Commission's third report, a significant portion of it consistent with the general stance of the Commission. The standard rate of VAT has fallen to 21 per cent and most goods and services are placed in this, or the 12.5 per cent, tax bands[25]. Electricity, agricultural services, farm accounting and management services, telecommunications services, legal services and adult clothing and footwear, all previously zero-rated or exempt, have been brought into the VAT net. The services of dental technicians and theatre and live performances have been granted exemptions, however, and food, children's clothing and footwear, passenger transport and admission to sporting events continue to be zero-rated or exempt. The hair industry was recently rewarded for its labour intensiveness (or its ability to organise an effective protest) by having its VAT rate lowered in the budget, signalling the government's intention to use the indirect tax system to 'create' employment. There are indications that in the future the standard rate will be set closer to the Commission's recommended single rate of 15 per cent, but the impetus for this reform, and the inclusion of more goods and services into the standard tax band in 1993, is probably due more to the forces/directives of tax harmonisation and the present financial constraints, respectively, than a detailed inspection of the third report by the government[26].

Excise duties remain high by EC standards but here again we see limited signs of tax harmonisation/competition at work (or perhaps a re-evaluation of the underlying externalities along lines suggested by the third report?). The following movements in the rates of excise duties are in line with the Commission's recommendations and in many cases our European obligations. Excise duties on hydrocarbon oil used in sea fishing abolished (1985), excise duty on betting and gambling reduced (1985), excise duties on motor parts and accessories, tyres and tubes abolished (1985,1986), excise duties on matches and mechanical lighters abolished (1990), rebate of excise duties to small brewers abolished (1988), excise duties on table waters reduced (1990), excise duty on cider increased to be in line with other alcohol products (1993), excise duties on different forms of tobacco standardised (1993), excise duty relatively higher on leaded petrol (1988,1989,1990), excise duties on auto liquid petroleum gas (LPG) reduced (1990,1993), excise duties on TVs and videos abolished (1992) and excise duties on cars reduced but replaced by a new registration tax (1992).

There has been no movement on the issue of local taxation over the last ten years and aside from the thresholds for the payment of the income related Residential Property Tax being reduced in real terms (1992), there has been no sign that the government intend to reintroduce a property tax. With respect to the recommendations on tax administration, much genuine progress has been made. Self-assessment was introduced for the self-employed in 1988, for the payment of corporation, and capital acquisitions, taxes in 1989 and for the payment of capital gains tax in 1990. Current year assessment was introduced in 1990. Payment of tax

at source has been expanded with the introduction of the deposit interest retention tax and the withholding tax on fees paid for professional services. The enforcement of the Residential Property Tax (RPT) is being facilitated by new restrictions on the transfer of relevant houses until all RPT has been paid. Consolidated tax collection is in the process of being implemented by the Revenue Commissioners. New powers of attachment were granted to the Commissioners in 1988. The Revenue Commissioners intend to avail of the use of third-party returns to catch tax evaders. There is a much improved flow of information to taxpayers from the Revenue Commissioners and there has been an increase in the level of consultation with professional bodies on the operation of the tax system.

4. ACTUAL AND PROPOSED REFORMS?

The most important recommendation of the Commission on Taxation surrounded the taxation of an appropriately defined income base. It is instructive to summarise the cumulative effects of changes to the direct tax system enacted over the past ten years. As demonstrated in the previous section, the effects of inflation on a non-indexed system has actually *worsened* the system. Effective, and marginal, tax rates have increased for the vast majority of taxpayers and the system is neither more efficient nor more equitable than it was ten years ago. The introduction of the income levy of 1 per cent in 1993 has further exacerbated the poverty-traps that were already inherent in the interactions between the Irish tax and social-welfare schemes and runs contrary to even the appearance of an improvement in the tax system.

Some minor moves towards a comprehensive income tax base have been achieved; decreases in the capital gains threshold, inclusion of fringe benefits and the effects of inflation on the capital acquisitions tax thresholds. Given the potential for capital flight at the end of 1992 it is even possible that the Commission would have revised its recommendations with respect to deposit interest retention tax along lines similar to present arrangements. Inflation has also facilitated the reduction in the real value of certain discretionary allowances, for example, mortgage interest relief. The real value of the PAYE and PRSI allowances has also been eroded by inflation. The introduction of the probate tax of 2 per cent in 1993, however, runs contrary to the Commission's central proposal that it is the recipient's comprehensive income that should form the appropriate tax base.

The yield from corporation tax has increased significantly since the Commission's reports were published. As regards the integration of the personal and corporate tax systems, further imputation will have to await European Community decisions/directives. Some costly tax expenditures have been allowed to lapse but the government has not resisted the temptation to introduce new incentives/distortions, the expansion of the business expansion scheme in 1993 being just the latest example.

The area of indirect taxation has witnessed the introduction of changes, even reform, consistent with the Commission's proposals. Much of this movement, it could be argued however, represents reactions to European Community directives, as opposed to actions based on the recommendations of the Commission on Taxation. There has been no movement in the area of local taxation, in particular, the introduction of a locally based property tax cannot be expected in the near-future. Tax administration has seen very significant improvements, much of it along lines suggested by the Commission.

Changes in the Irish tax system over the past decade seems to emanate predominantly from two sources; inflation and the 'European process'. Inflation has been allowed to gradually erode politically sensitive allowances, deductions and reliefs through a lack of indexation and European tax competition has forced explicit legislative changes upon us, with, of course, the usual delegation of responsibility. The budget speech of 1993 is no exception:

"The Community agreements permit the application of only one rate in excess of an agreed standard rate minimum level of 15 per cent."

"EC law requires a fundamental change to the VAT treatment of building services."

"Internal Market rules dictate that a single rate of duty must apply to all pipe tobaccos."

(Irish Times, February 26)

Some arguments have been put forward to justify the non-implementation of the Commission's package of tax reforms. It has been suggested that one, ultimately major, flaw in the work of the Commission was its insistence that the package had to be accepted in its entirety. It is argued that this gave every government since the early 1980s an escape option as it was not difficult to find some individual recommendation politically, and perhaps economically, unacceptable in a particular environment, and that consequently the package as a whole could not be implemented. Critics neglect to follow the alternative path to its logical conclusion. A menu of recommendations would pose little difficulty for any government but would surely have led to an even more distorted tax system.

A more constructive, but related, criticism of the Commission was its lack of emphasis on the major recommendations of the five reports. Almost four hundred detailed recommendations are apparently given equal weighting. Approximately 50 per cent of the recommendations are, to some extent, emphasised via their inclusion in introductory chapters or chapters outlining the key elements of proposed reforms but a smaller list of essential reforms may have better focused the politician's mind.

The truth in the political reality that underlies the above arguments, however, has been countered by NESC (1986,1990) and its outlining of subsets of the most important recommendations of the Commission's reports that could be regarded as 'stand-alone' packages. These proposals have for the most part suffered the same fate as the Commission's reports. There are some mildly encouraging moves towards implementing some of the recommendations of the Industrial Policy Review Group and it will be interesting to see which subset of their proposals is implemented eventually.

A final possible criticism of the Commission's package lies in the argument that the optimal tax system has no particular claim to be the optimal tax reform package. Feldstein (1976) yields three arguments that would lend support to a slow but steady implementation of the optimal tax system. New entrants to the market can make fully informed and hence optimal economic decisions[27]. Existing participants in the market will find that the present value of their losses/gains will be smaller under a phased implementation and finally, as factors leave/enter the market in question, the compensation to the remaining factors will increase/decrease, offsetting to some extent their initial losses/gains[28]. It is essential to note that these arguments depends crucially on the announcement of, and the commitment of the government to, future tax reforms. Although the government is reluctant to tie its hands with respect to future tax changes, the gradual withdrawal of the relief on life assurance premiums is an example of a smooth transition along the lines favoured by Feldstein. The erosion of nominally fixed tax reliefs, deductions and allowances by inflation is, to some extent, tantamount to an announcement. Mortgage interest tax relief (MITR) and the gradual erosion of its real value up until 1992 provides an illustrative example of the powers of 'doing-nothing'. Inflation and the non-indexation of the tax system can act as a structure that signals a credible commitment to the eventual removal of distortions by the government. There is no need for the government to take on all concerned interest groups when inflation can implement desired policy.

The above argument must not be taken too far. Any dynamic welfare gains suggested by the phasing-in of tax reforms must be weighted against the traditional welfare losses associated with the distortion to the existing tax system. Flemming (1990) also notes that a constant tax distortion of 25 per cent is to be preferred to a combination of distortions caused by the existence of a initial 30 per cent rate followed by a 20 per cent rate. Douglas (1990) outlines several arguments, based on significant political experience, that support the implementation of tax reform by a 'big-bang' approach. Central to his arguments is the pitching of winners against losers, the unlikelihood of there being many significant losers on aggregate and the out-manoeuvring of vested interests. Flemming notes that the phasing-in of reforms can also lead to extra economic distortions as people will postpone their work effort and purchases if they believe that direct and indirect rates will fall in the near-future. It would seem that the phasing-in of tax rate changes should proceed at a faster pace than the phasing-out of tax concessions.

The indexation of the Capital Acquisitions Tax thresholds in 1991 combined with the introduction of a 2 per cent probate tax in 1993 and the recent significant increase in mortgage interest relief (1993) signal the demise of gradualism in an Irish context. The latter example also demonstrates the ability of vested interests to regroup if given sufficient time and political encouragement. The inability of the government to make justifiable concessions on the MITR front contingent on high interest rates is particularly noteworthy. It would appear that *in an Irish context* the political and economic arguments in favour of the 'big-bang' approach are more convincing than the arguments in favour of 'gradualism'.

5. CONCLUSION

Since the mid-1980s tax revenue as a percentage of GDP in Ireland has stabilised. It seems reasonable to suggest that the tax revolt of 1980 was caused by the realisation that the tax burden in the following years had to increase and its main purpose, and ultimately its effect, was to prevent future increases in the tax burden. In terms of the composition of Irish tax revenue, the 'tax-revolt' succeeded in halting but not reversing the trend towards the increased taxation of personal income. As Table 1 demonstrates indirect taxation in Ireland remains extremely high by the standards of our European partners and it is becoming increasingly difficult to be different in an integrated European market. This is demonstrated by the government's need to introduce lower tax rates on interest income to prevent capital flight. The Irish tax system must in the near-future confront some more awkward questions that will be posed by tax competition in goods and services.

Since the publication of the Commission's reports changes have been made in the Irish tax system but little tax reform has been implemented. <u>Nominally</u> much of the changes are along the equitable taxation lines advocated by the Commission, in that tax bases have, to some extent, been extended and tax rates have been lowered. It remains the case, however, that in <u>real</u> terms the tax system retains many examples of horizontal inequities due to the differential taxation of incomes and assets derived from different sources. Taxation of the average industrial wage is at a higher rate than was the case ten years ago.

It has been argued in this paper that by design or accident, inflation and the prospects of European tax competition have driven much of the changes in the tax system that have occurred in Ireland. If even this was done in a consistent manner, it would have its advantages as outlined by the gradualist's approach to tax reform but as demonstrated by the recent experiences of MITR, the government seem incapable of confronting the rent-seekers that invariably appear in an environment where tax policy has no foundation and little structure.

The blueprint for the necessary, and ultimately inevitable, radical reform of the Irish tax system: the reports of the Commission on Taxation, remain as relevant today as

they were almost ten years ago. The similarity of the National Economic and Social Council and the Industrial Policy Review Group's proposals to the recommendations of the Commission on Taxation bears testimony to this. The alternative, implicitly chosen by successive governments, of allowing the rate of inflation, the rent-seekers and the transformation of Europe into a Single Market dictate the course of Irish taxation policy should no longer be acceptable.

Footnotes

1. For example in 1978 California passed into law Proposition 13 which dramatically reduced state taxes and expenditures and placed constitutional limits on future increases in tax. See Swartz (1991) for an overview of the subsequent tax and expenditure revolt in the United States.
2. Gross National Product (GNP) and Gross National Disposable Income (GNDI) are superior measures of Ireland's economic well-being. Gross Domestic Product (GDP) is used for the purposes of comparison across countries as in many countries GNP and GDP are almost identical. During the 1980s Ireland's GNP has been approximately 90 per cent of its GDP.
3. This paper concentrates on the taxation side of the budget. An appreciation of the issues involved on the expenditure side of the budget is essential. In an Irish context, high dependency ratios, increasing levels of unemployment and the increase in debt servicing costs form just part of the appropriate background to this paper.
4. Sandford notes the difficulties of comparison across country and time due to the presence of social security contributions and local taxes.
5. Although corrective taxes which internalise externalities do exist, it is assumed that they alone cannot finance the desired level of public expenditure.
6. Ringen (1987 Chap. 8) questions this conventional wisdom by focusing on the counterfactual problem underlying the economic analysis of the tax system.
7. See Buchanan (1976) and Brennan & Buchanan (1980) for an overview of the Fiscal Exchange (FE) approach to tax policy/reform. This school had some impact in the US during the 1980s, for example, with the move away from the adoption of a VAT and with calls, ultimately unsuccessful, for a balanced budget amendment to the US federal constitution.
8. The bloodstock industry provides an illustrative example of the Commission recognizing the mobility of certain industries and adopting an OT position.
9. Other direct tax considered by the Commission were a direct expenditure tax and a wealth tax. The former is incorporated into the blueprints for the purposes of achieving the required degree of progressivity and the latter was considered inferior in the context of the total tax reform package developed by the Commission.
10. An income tax rate of 25 per cent was used by the Commission for purposes of illustration.
11. A fuller treatment of issues involving the effects of discriminatory taxation on the Irish savings market can be found in Thom (1988). The difficulties encountered in simultaneously achieving fiscal neutrality across assets and both horizontal equity and vertical equity in a tax system are neatly summarized by Leape (1990).
12. Neutrality w.r.t. the cost of capital actually implies a choice between free depreciation and true economic depreciation <u>plus</u> the deductibility of finance costs. Neutrality w.r.t. the debt/equity choice requires a deduction for interest

payments and an appropriate allowance for corporate equity. See Gammie (1992) for details.

13. For a transitional period, the existence of two rates (10% & 18% or 8% & 22%) is stressed by de Buitleir (1984).
14. Theoretically differential commodity taxation is proposed by the OT literature if there exists a link between the consumption of particular commodities and the utility derived from the consumption of leisure.
15. It may be more consistent to view betting duty as a proxy for a consumption tax on betting.
16. For complete neutrality, indexation should actually be in line with the growth rate of nominal output, not only the inflation component.
17. Hederman O'Brien (1982) suggests that the introduction of the expenditure tax should follow the indexation of the tax system.
18. See NESC (1986,1990) for a description and an analysis of changes in the effective and marginal tax rates within the ten year period.
19. The UK government reacted to similar criticism in 1992 by introducing an initial tax rate of 20 per cent as compared to their standard rate of 25 per cent.
20. The efficiency costs increase with the square of the marginal tax rate, e.g. a marginal tax rate of 2 per cent creates four (not two) times the efficiency loss of a 1 per cent marginal tax rate.
21. In March 1992 the Ruding Committee's report on European tax harmonisation recommended the imposition of minimum (30%) and maximum (40%) corporate tax rates and the adoption of a common corporate tax base across the European Community. The EC Commission's initial reaction was to reject the concept of a maximum rate and to suggest the lowering of the minimum rate. If eventually adopted, many of the Committee's recommendations will have a significant impact on Ireland's current corporation tax system.
22. For a comprehensive overview of the effects of fiscal policy on urban renewal in Ireland, see Foundation for Fiscal Studies (1991).
23. Tax relief is available on £2,150 of mortgage interest during 1992/93 as a 'temporary' reaction to high real interest rates. Tax relief is available on £2,400 of mortgage interest to first-time buyers. Section 23 reliefs, introduced as part of urban renewal, also complicate the comparison.
24. Only first round effects are considered in the above tables. For example, it is assumed that the gross income of artists would remain unchanged after the introduction of income tax. The elimination of the above reliefs would not be expected to yield the indicated totals after the present recipients' reactions are taken into account.
25. This section on indirect taxation draws on de Buitleir (1990) and NESC (1990).
26. The European proposals seem to accept the potential existence of four rates of VAT - a standard rate of not less than 15 per cent, possibly two rates between 5 per cent and 15 per cent and the continued existence of a zero rate on some commodities.

27. The immediate adoption of the 'optimal' tax system would also have this efficiency property.
28. Another possible justification for inaction is provided by noting that the value of the tax advantages are to some degree capitalised into the price of the assets and the immediate removal of MITR, for example, would have serious distributional consequences.

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DISCUSSION

Jim O'Leary: Francis O'Toole is to be congratulated on his thoughtful and erudite paper which represents an attempt to relate the changes that have taken place in the Irish taxation system over the past decade or so to the blueprint for reform produced by the Commission on Taxation.

His conclusions as I read them are that taxation policy since the 1980s has not been particularly coherent, that it has been capricious in its accordance with the principles advocated by the Commission, and that where it has been faithful to those principles its fidelity has been due primarily to the intervention of exogenous factors such as inflation and the requirements of EC harmonisation. This seems like a reasonable verdict. Some might argue with the restraint he demonstrates in delivering it.

If I were to choose grounds upon which to criticise the author it would be to suggest that his approach lays too much emphasis on taxonomy (no pun intended!) and not enough on identifying the reasons why taxation policy has evolved the way it has done and why, for the most part, successive governments have eschewed so much of what the Commission recommended. At the recent IEA conference on unemployment Kieran Kennedy posed a similar question in relation to labour market policy and suggested that economists interested in policy should spend some time trying to answer it, all the better to maximise their chances of influencing policy in the future.

Why has the Commission's monumental work exerted such limited influence on policy? There are many reasons. One of them is suggested by a point made in the early part of tonight's paper where the distinction is drawn between the two major approaches to the design of a tax system - Equitable Taxation and Optimal Taxation. O'Toole suggests that the Commission adhered to the former approach. No doubt there are members of the Commission who would argue with this, but the point is that O'Toole's remarks reflect a popular perception.

Whether through any fault of the Commission or not, the reform programme it advocated was seen to be essentially concerned with redistributing the tax burden. From the outset, media coverage of its reports centred on the questions of who stood to gain and who stood to lose from its proposals. Indeed, to this day, the first port of call in popular analysis of any proposal to change the tax system is the same: who wins; who loses? More often than not it is also the last port. Tax reform has been reduced to a matter of distributive arithmetic and is seen as a zero-sum game. Politicians have taken to this game with enthusiasm. How many times in recent years have we heard Ministers for Finance parry a question on tax reform by insinuating that tax reform is nothing more than window-dressing for robbing Peter to pay Paul?

One could argue that the most important failure of those who have advocated tax reform in this country is that they have not persuaded policy-makers of the probability of *efficiency gains*. There is little evidence to suggest that politicians believe that tax reform can improve overall economic performance. Perhaps this is all a measure of how infected our policy-making has become by the *rentier* mentality: that efficiency is a concept that exists only in the models and textbooks of economists and that real economic activity is all about exploiting fiscal privilege, tax expenditures and other reliefs and creating new ones.

Of course there is another dimension of distribution that helps explain why the Commission's blueprint won few friends in Merrion St., namely the distribution of revenues between the state and its citizens. Bear in mind that when the Commission published its first report in 1982 the public finances were headed towards crisis, and by the time the last report was published three years later that crisis was upon us. Thus the public policy agenda had been transformed between the time that the Commission was established in 1980 and the time its corpus of work was completed. By the latter date the full resources of the policy-making establishment were directed towards rescuing the Exchequer from disaster.

According to the official view this was not the time for radical tax reform. It was not the time for taking risks with tax revenues. I recall from my days at NESC in the mid-1980s that the Department of Finance representative on the Council steadfastly articulated the view that the only changes to the tax code that could be contemplated in the circumstances were those to which reliable estimates of revenue raised or foregone could be attached, and that in the latter case they would have to be offset by other measures that would produce an overall outcome that was deficit-neutral. This approach left little scope for factoring in the necessarily speculative estimates of the effect of efficiency gains on revenues.

An implication of this attitude was that the probability of a thorough-going overhaul of the tax system would only become non-trivial when the fiscal crisis was past and the public finances were back on a reasonably sound footing. For those who approached tax reform as a purely redistributive exercise this made perfect sense. After all if tax reform *per se* is viewed as a zero-sum game with politically unpalatable side-effects, why not postpone the project until the political downside can be neutralised by reducing tax revenues. Why rob Peter to pay Paul when you can give the pair of them a few bob? When the state of the public finances palpably improved in the late 1980s this bowdlerised version of tax reform provided the inspiration for policy.

There are just two other thoughts I would like to express before drawing my remarks to a close. The first is to support a point that Francis O'Toole makes in his paper, namely that the Commission made a strategic mistake in insisting that its proposals for reform comprised a single indivisible package the integrity of which would be compromised by selective implementation. This proved to be a gift to those who were waiting in the long grass to shoot down the Commission's work.

I have never understood why the Commission adopted this approach. Was it *hubris*? Not only was their repudiation of anything short of full implementation a strategic mistake but it was, I believe, a logical error. The NESC's 1986 report *Strategy for Development*, amply demonstrated the feasibility of introducing coherent subsets of the Commission's overall package.

Finally, we can only begin to understand why the Commission's blueprint for reform was effectively ignored by successive governments if we recognise that the policy agenda is dominated by different issues at different times. Tax reform may have had a position of some prominence on that agenda in 1980 when the Commission was established against the background of the PAYE protest marches, but it had become an irritant to policy-makers by the time the Commission completed its work.

As best we can figure out, the issue that has been promoted to the top of the policy agenda at this stage is unemployment. The current primacy of the unemployment issue might suggest that now at last the climate is conducive to giving weight to efficiency issues in the matter of taxation policy. However, the 1993 budget, with its introduction of the new 1 per cent levy, wouldn't encourage one to hold one's breath in this regard. Nor is it clear that the Commission's reports necessarily provide a comprehensive blueprint for efficiency-driven tax reform given their silence on one of the areas where problems of efficiency are most obvious namely the interface between the tax and social welfare systems and on the question of the composition of overall tax revenue as between the main categories.

Norman Gillanders: Mr O'Toole's paper indicates that there have been two phases to the evolution of our tax system in the past ten years or so. During the first phase which extended roughly from 1982/83, Mr O'Toole's base year, to 1987/88 or 1988/89 there is little evidence that the Commission on Taxation had any major influence on taxation policy. However as someone who has worked in the policy and legislation area of the Revenue Commissioners' office over the entire period covered by Mr O'Toole's paper I feel that the structural problems of the tax system began to be tackled from the late 1980s onwards. A coherent view has informed tax policy since then. Take personal income tax as an example. It was clear that the income tax burden was too high and needed to be reduced at all income levels. In particular:

- The standard rate was too high and had to be reduced. In 1982/83 and in 1988/89 it was 35 per cent. It is now 27 per cent.

- The standard band was too narrow and had to be expanded. In 1982/83 the limit of the standard band was reached at £4,000 of taxable income for a single person. [£1,000 at 25% plus £3,000 at 35%]. In 1988/89 that limit was £5,700 and it now stands at £7,675.

- The top rate of tax was too high and had to be reduced. In 1982/83 the top rate was 60 per cent. In 1988/89 it was 58 per cent and it is now 48 per cent.

- The tax threshold was too low and a way had to be found to give relief to low income workers. It is extremely expensive to increase the personal allowances. so, low income families were given relief by increasing the tax exemption limits and by introducing a higher exemption limit for families with children. The married persons' exemption limit rose from £4,400 in 1982/83 to £5,500 in 1988/89 to £7,200 in 1993/94. For married cases with children the improvements are greater.

By measuring the effective income tax rates against the average industrial wage Mr O'Toole plays down some of this progress since during his reference period the average industrial wage has risen by about 96 per cent whilst the CPI has risen by only 57 per cent. If you look at tax and PRSI as a percentage of constant real incomes (which have just kept pace with the CPI) then there is a marked decline in effective tax rates across all income ranges starting in 1988/89. This is true for single and married taxpayers.

You can look at this another way. If the 1982/83 tax rates, bands, allowances and exemption limits were reinstated in 1993/94 on a fully indexed basis, the Exchequer would gain over £550 million in a full year.

Don Thornhill: I would like to join the principal respondents and other speakers in commending Francis O'Toole's paper.

I have often argued that the reports of the Commission of Taxation are an ideal place to begin to familiarise oneself with the Irish tax system. Francis O'Toole's paper is an ideal supplement to these reports and indeed any policy-maker, observer or analyst approaching the Irish tax system would do very well to read his report as a supplement to the reports of the Commission. Indeed, it is an indication of my broad agreement with his paper that the comments I have to make relate to the remarks made by the respondents!

First of all I share much of Jim O'Leary's analysis. It is rare, I think, for representative democracies to focus on a single policy objective. The period post

1987 when there was a consensus on the restructuring of the public finances, probably represents an exception. Usual public policy proceeds by way of an organic cellular process rather than in a linear way. Policy-makers must contend with multiple stimuli and pressures including the activities of interest groups. Accordingly the process of major reform is very difficult. Jim O'Leary is also correct in identifying the need to restore balance in the public finances as a very important influence on tax policy during the eighties, particularly the late eighties.

I also have a very brief comment to make on Noel O'Gorman's excellent overview of the tax system since the early eighties as it relates to the influence of EC policy on indirect tax developments. His observations and my comments are interesting in the context of the psychological phenomenon that two people in the same locality can have very different impressions of the same event! Certainly my impression of indirect tax policy developments in the late eighties and early nineties was that the EC Single Market proposals had a major bearing. Noel indeed and I had worked in this area together during that period at our respective desks in the Department of Finance and Office of the Revenue Commissioners. I don't think that we need to be defensive about this influence. Surely, it is good policy to make a realistic response to external developments?

Reply by Francis O'Toole: I wish to thank the respondents for their most helpful comments and the contributors to the informative general discussion which followed the paper. I see many of the respondents' views as being complementary to, rather than conflicting with, the views expressed in the paper.

I must plead guilty to J. O'Leary's point about the paper being somewhat overly-descriptive about the lack of real tax reform in Ireland during the period in question but somewhat lacking in an analysis of the factors that could have explained this inertia. It was a strategic decision to narrow the scope of the paper to analyse "what happened" rather than "what happened and why did it happen?". J. O'Leary has summarised very neatly a plausible explanation for the government's inactivity. The efficiency gains resulting from tax reform may simply not be recognised and even if recognised may fail to be adopted owing to a somewhat cautious approach adopted by the Department of Finance. It is most unfortunate if tax reform in an Irish context can only be attempted in the good times as tax reform as advocated by the Commission on Taxation in many respects actually points the way to the good times. The limitation of tax reform to the good times also runs the risk of cementing in our minds the false belief that tax reform invariably implies a decrease in tax.

N. Gillanders' points are well-taken and serve to identify an underlying difficulty in comparisons involving the tax system across time periods - should the appropriate benchmark for indexation be based on adjustments made for inflation or adjustments made for improvements in living standards? While it is true that the Exchequer would have gained substantially if the 1982/82 tax system had been CPI-indexed,

this increase would also have implied a substantial increase in the proportional of tax paid by all taxpayers. This increase would have been neither efficient nor equitable. The paper shows that much change has occurred in the *relative* shares of tax payments across groups of taxpayers but that these changes could hardly be referred to as reform.

D. Thornhill's comments draw attention to the influence of interest groups in the context of tax reform. The Commission on Taxation opted for the adoption of a comprehensive package of tax reforms to overcome this very problem. Unfortunately, this decision in itself provided an alternative excuse for those unwilling to accept tax reform.