Minister Paschal Donohoe TD  
Department of Finance  
Government Buildings,  
Upper Merrion Street,  
Dublin D02 R583,  
Ireland  

25th August 2017  

Dear Minister Donohoe,

The Institute for Fiscal Studies (IFS) is Britain’s leading independent microeconomic research institute, founded with the principal aims of informing public debate on economics and promoting the development of effective fiscal policy. We are writing to you as researchers based at the IFS to comment on some proposals contained in your Department’s Budget 2018 Tax Strategy Group (TSG) Papers. We commend the publication of these documents in advance of the Budget in order to facilitate informed discussion.\(^1\) We focus our comments on three proposals with parallels or precedence in the UK, drawing on both our own previous work and that of colleagues at the IFS.

‘Tapered withdrawal of tax credits’

TSG paper 17-02 considers a proposal to remove the PAYE and Earned Income tax credits – which reduce final income tax liabilities – from taxpayers with higher levels of income. The proposal appears to be in-part inspired by a similar feature of the UK tax code – termed the ‘withdrawal of the personal allowance’ – that results in a marginal income tax rate that rises from 40% to 60% at £100,000 per year before falling back to 40% at £123,000 per year.\(^2\)

Withdrawing these tax credits would further complicate what is already a remarkably convoluted tax schedule, shown in Figure 1 for the employment earnings of a single adult without children. The effective marginal tax rate from income tax, the Universal Social Charge (USC) and class A (employee and employer) PRSI rises sharply below €20,000 of annual gross income. This is because from €16,500 p.a., individuals face the basic rate of income tax while from €18,304 p.a. individuals’ class A PRSI credit is withdrawn at a rate of 1/6 on top of income tax, PRSI and USC. Once the PRSI credit is fully withdrawn (at around €22,000 p.a.), the effective marginal rate falls back down to 35.9% before rising again with the higher rates of income tax and USC. Withdrawing tax credits at a rate of 5% from those with annual income above €100,000\(^3\) would create an effective rate of 64.1% between €100,000 and €120,000 p.a.


\(^2\) Income tax in the UK operates through a system of allowances and bands of income. Each individual is entitled to a personal allowance, which is deducted from total income before tax to give taxable income. Since 2010—11 this has been reduced by 50p for each £1 of income above £100,000, creating an effective 60% rate band as the extra 50p of taxable income is taxed at the 40% higher rate, adding 20p to tax liability on top of the 40p tax on the £1 itself. For more, see [https://www.ifs.org.uk/publications/1711](https://www.ifs.org.uk/publications/1711).

\(^3\) As suggested in Paragraph 49 of TSG paper 17-02.
A basic requirement for any system of taxing earnings is that the rate schedule should be transparent. If setting an effective marginal tax rate of 64.1% on employment income between €100,000 and €120,000 is to be the objective of policy, then it should be explicitly stated in the marginal rate schedule, not described opaquely as a ‘tapered withdrawal of tax credits’: this peculiar mechanism serves no purpose except to obscure what the tax system is actually doing.

As with any tax increase, withdrawing tax credits would have negative effects on welfare and economic efficiency. Higher marginal rates reduce economic efficiency by weakening the incentive for individuals to increase their earnings. The extent of this effect is primarily determined by a) the size of the change in marginal tax rates, b) the number of taxpayers affected and c) how responsive those affected are to changes in marginal tax rates. Given the proposal to withdraw tax credits from higher earners in full, there is a direct trade-off between the first two of these: the slower the tax credit is withdrawn, the smaller the increase in marginal tax rates will be, but for more taxpayers than if withdrawn faster (and vice versa).

Evidence on how responsive taxpayers are to changes in marginal tax rates at this level of income is mixed. Our own research shows that in the UK there is only a small amount of ‘bunching’ in the distribution of income around the £100,000 threshold, suggesting most taxpayers are relatively unresponsive at this level of income. However, there is substantial bunching among company owner-managers, who have considerable flexibility to adjust the timing and amount of dividend income they take.4

4 See https://www.ifs.org.uk/publications/9679, especially Figures 4 and A2.
In addition to raising marginal rates for some taxpayers, withdrawing tax credits as suggested would also increase average tax rates for all those with incomes above €100,000. By reducing the income these taxpayers receive for a given number of hours of work (or effort), this could encourage these taxpayers to work more to limit any decline in living standards. However, the empirical literature suggests that such ‘income effects’ are small in magnitude, and dominated by the ‘substitution effects’ described above, especially for higher-income employees.\(^5\)

Increasing average tax rates can also affect decisions at the ‘extensive margin’ – whether to undertake paid work at all. This may be particularly important for the affected group here, as Revenue statistics\(^5\) show that more than two-thirds of tax units with incomes above €100,000 are two-earner couples and the empirical literature suggests that extensive margin responses for second-earners can be significant.\(^7\) If tax credits were withdrawn against joint income, the increase in average tax rates could discourage the labour market participation of some second earners, or – depending on their own and their spouse’s level of earnings – lead them to elect to be individually assessed so as to retain the full value of their tax credits. If instead, tax credits were withdrawn against individual income, far fewer taxpayers would be affected, reducing the efficiency losses but also the revenue yield from the tax rise.

**Introduction of a Minimum Unit Price for alcohol**

TSG paper 17-07 details the Irish Government’s plans for the introduction of a Minimum Unit Price (MUP) of €0.10 per gram of alcohol, below which it would be illegal to sell or advertise alcohol products. The stated rationale for introducing a MUP is to reduce the social costs of problem drinking.\(^8\) As well as being related to high levels of consumption, research suggests that these cost are highly non-linear (e.g. the tenth pint of beer in an evening is likely to cause much more harm than the first) and vary across consumers (e.g. the tenth pint of beer for someone prone to alcohol-fuelled violence is likely to be more harmful than the tenth pint consumed by the convivial drunk).

The current system of Alcohol Products Tax (APT) may do a poor job of targeting these costs because it does not systemically tax higher-strength alcohol products – which in the UK are disproportionately consumed by heavy drinkers – more than weaker-strength ones. Figure 2 shows this, plotting the current structure of APT measured per unit of alcohol.

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\(^6\) Revenue income tax distribution statistics RVA01 for 2015.


For spirits and spirit-based alcopops, the tax levied per unit of alcohol is constant in strength. For beer, the tax per unit of alcohol increases with strength; strong beers attract a higher tax rate than mid-strength beers, which in turn attract a higher tax rate than low-strength beers. For wines and cider, the tax per unit varies by type and declines in strength, with discrete jumps at several points. The level of taxes on alcohol also clearly vary by type of product and not in a way that necessarily relates to social costs (e.g., there’s no evidence that we expect those drinking sparkling wine to create more social costs than those drinking beer).

A MUP would increase the relative price of cheap alcohol, and would therefore target heavy drinkers to the extent they consume alcohol products that are cheaper in per-unit terms. However, a MUP is much less well targeted at increasing the relative price of strong alcohol products (as not all high-strength alcohol products are cheap). A MUP would also generate significant windfall revenues for alcohol retailers and manufacturers while reducing revenues from alcohol taxes.

Research by colleagues at the IFS has demonstrated that it would be possible to target heavy drinkers more effectively by reforming taxes so that they increase in alcohol strength than by introducing a MUP. Such a reform would also lead to an increase in tax revenues, compared to a decrease associated with the introduction of a MUP.

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The scope for such a reform to excise duties is currently restricted by the European Council Alcohol Products Directive (92/83/EEC), which sets out that the tax base for wine and cider should be the volume of liquid, whereas the base for spirits and beer is the alcohol content. However, the European Commission are currently preparing an impact assessment report on possible changes to this directive, which may allow greater scope for targeting duties at higher strength alcohol products. Even within the constraints placed by the Directive, APT could be reformed to better target alcohol consumed disproportionately by heavy drinkers, for instance, increasing APT on cider and spirits relative to other alcoholic drinks.

Changes to entrepreneur relief
TSG paper 17/11 outlines potential changes to – including the abolition of – entrepreneur relief. This is a reduced capital gains tax (CGT) rate of 10% that applies to chargeable gains (up to a lifetime limit) on certain eligible assets, most notably those owned by a trading company (or holding company of a trading group) of which the shareholder has been a full-time employee or director and owned at least 5% of the shares for a continuous period of 3 years in the 5 years immediately prior to disposal.

As we have previously noted in the UK context, entrepreneur relief adds complexity to the tax system, by creating a distinction between qualifying and non-qualifying assets and requiring records of disposals to be kept (and audited) in order to enforce the lifetime limit. It also creates an array of economic distortions. First, it encourages owner-managers of companies to retain profits in the company rather than take them out as dividends or salary and for self-employed individuals and partnerships to retain business assets until they are ready to stop doing business altogether. Entrepreneur relief creates these incentives regardless of whether (in the absence of tax considerations) business owners would rather spend their money sooner or could invest it more profitably elsewhere or whether assets could be more profitably used by others. Second, it provides a strong incentive to set up a business in which to retain profits, putting pressure on anti-avoidance rules, which attempt to define when companies are ‘artificial’ avoidance devices. Third, it gives companies an artificial incentive to ensure that any individual employee shareholdings are above 5%, rather than below that threshold.

The justification for applying lower tax rates to people who own their own business than to the rest of the population is far from clear. Preferential capital gains rates are often defended as essential to reward difficult and risky entrepreneurial activity. But the difficulty and risk associated with entrepreneurship do not in themselves justify favourable tax treatment (the market usually rewards these activities). What is needed (though not necessarily sufficient) is some rationale why the market will lead to too few ‘entrepreneurs’ when the tax system is neutral between legal forms.

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Good examples of such market failures include there being too few new ideas tried out because innovators do not reap sufficient rewards from their innovation (some ‘spill over’ to other businesses that can learn from the experiences of the innovator); and some small and/or new firms finding it prohibitively expensive to raise external finance because potential lenders have less information than would-be borrowers about the firm’s prospects. But there is little evidence to suggest that that reduced rates of capital gains tax are well targeted at alleviating any concerns around business start-ups, or that those who qualify for entrepreneur relief carry out activities associated with large spillovers. Indeed, it is hard to find a coherent question to which reduced capital gains tax rates for owners of certain business assets is the best answer. If the goal is to encourage investment, the Mirrlees Review argued that this can be better achieved by providing relief for amounts invested than by giving reduced tax rates on actual investment returns.\textsuperscript{11}

There is a good argument that the benefits of scrapping entrepreneur relief (including reduced complexity, fewer avoidance opportunities and distortions and increased fairness) would outweigh the cost of increasing the tax on the return to certain investments. Ensuring that the tax system does not discourage investment and targeting specific market failures could be much better achieved through other policies.

One caveat to this is tax competition. As highlighted by the TSG paper, scrapping entrepreneur relief in Ireland while it continues to exist in the UK would provide an incentive for Irish business owners to dispose of assets in the UK rather than Ireland, distorting business location decisions and reducing revenues in Ireland. Ideally, the policy would also be removed in the UK.\textsuperscript{12} While it remains in the UK, tax competition concerns could reduce the case for scrapping the relief in Ireland. How much of a concern this is depends on the degree to which individuals would respond by disposing of assets in the UK rather than Ireland: something we are not aware of any evidence on.

Once again, we commend the Department’s initiative of publishing the TSG papers in advance of Budget 2018, and hope that our comments can assist the Department in improving the design of the tax system in Ireland. We would be happy to clarify any of the points raised in this submission.

With best wishes,

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\textsuperscript{12} Indeed, the UK Government expect to publish an evaluation of entrepreneurs’ relief in the coming months.