

Pre-Budget 2011 Submission

November 2010

NCC Pre-Budget 2011 Submission

The National Competitiveness Council (NCC) welcomes the opportunity to make a submission to the Minister and Department of Finance in regard to Budget 2011.

Restoring the Irish economy to sustainable economic growth is essential both to reducing unemployment and restoring fiscal balance. Solutions cannot be viewed in isolation - by prioritising actions to support the enterprise base to compete in increasingly competitive global markets we will go a long way towards resolving our fiscal and banking challenges. While Irish competitiveness has improved in the past 18 months, further action is required to develop a sustainable competitive operating environment for all businesses and to enable Irish exporters to trade successfully in difficult international markets.

The NCC supports the Government's commitment to restore the sustainability of the public finances but it is critical that it is achieved in a way that:

- continues to support economic growth, competitiveness and job creation; and
- protects those on low incomes and social welfare benefits while strengthening incentives to remain in or return to the labour market exist.

The fiscal actions identified by the NCC to enhance Ireland's international competitiveness are grouped under four headings:

1. Supporting enterprise competitiveness

- Maintain a competitive labour tax wedge to encourage labour market participation;
- Keeping people close to the labour market;
- Review the R&D tax credit; and
- Improving the competitiveness of domestic sectors.

2. Raising revenues

- Broaden the tax base by introducing a value based property tax on residences; and
- Introduce user charges to reflect the costs of services provided.

3. Reconfiguring expenditure to underpin economic growth

- Eliminate tax expenditures that do not support the productive sector;
- Review local authority charges; and,
- Promote e-payments.

4. Improving fiscal policy and delivery

- Improve the fiscal planning framework.

1. Supporting enterprise competitiveness

1.1 Maintain a competitive labour tax wedge to encourage labour market participation

The tax wedge on labour is the gap between what the employer pays and what the employee receives. A competitive tax wedge is vital to encourage employment growth across all income categories and is an important competitive advantage in attracting and retaining highly skilled and internationally mobile workers. In Ireland, the labour tax wedge has risen for all income categories assessed by the OECD (Table 1 and Figure 1) since 2008 while the tax wedge in most OECD countries is unchanged or falling.

Table 1: Total tax wedge on labour (as a % of average earnings) - Ireland and the OECD¹

Income category	Ireland		OECD average*	
	2008	2009	2008	2009
Single - no children				
67% of average wage	20.2	22.5	33.5	32.5
100% of average wage	27.0	28.6	37.0	36.4
Married - 2 children**				
133% of average wage	18.8	20.5	33.8	33.2
167% of average wage	17.5	19.8	31.8	31.6

Notes: * OECD average is unweighted; ** Represents the combined income of a married couple.

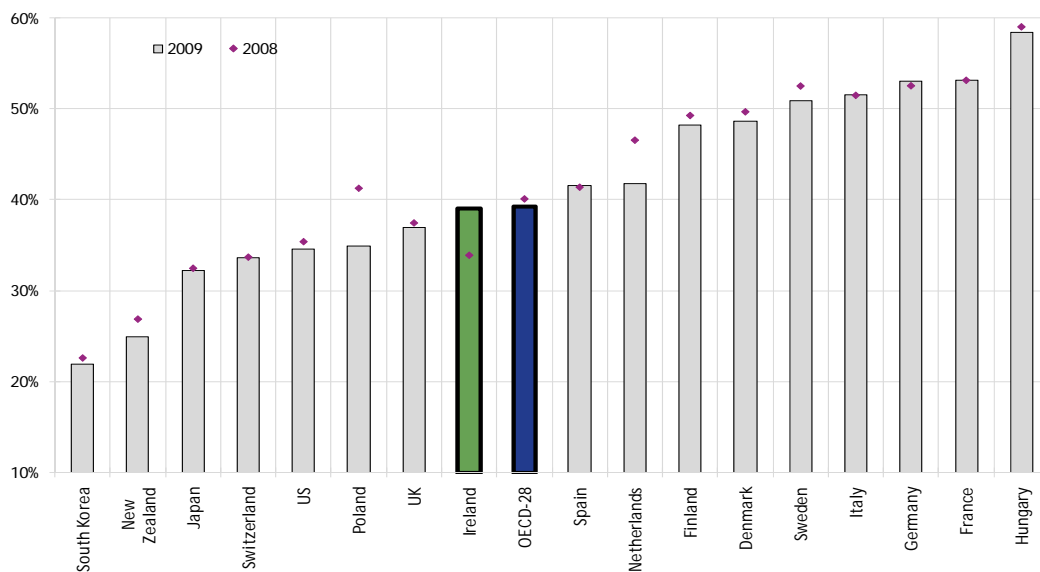
While Ireland's tax wedge compares favourably to the OECD average for the income categories included in Table 1, Ireland has become significantly less competitive for higher income earners (Figure 1). The highest income category included in the OECD report is for a single person on 167 per cent of the average wage (with no children). For such a person, the tax wedge increased from 34 per cent in 2008 to 39 per cent in 2009 compared to the OECD-28 average which declined from 40.2 per cent in 2008 to 39.3 per cent in 2009.

1.2 Keeping people close to the labour market

High replacement ratios between social welfare (direct payments and secondary benefits) and net pay for employment weaken incentives to return to the labour force. Further work is required to assess the labour market effects of the taxation and the social welfare system. A major challenge exists to protect those on low incomes and social welfare benefits while ensuring that incentives to remain in or return to the labour market are strengthened and that businesses are incentivised to take on additional staff (e.g. internships, overseas marketing assignments).

¹ In 2008, Ireland (41 per cent) had the ninth highest personal income tax rate in the EU-27. As the only EU country to increase personal income taxes in 2009, Ireland's ranking was the sixth highest in 2009 (46 per cent). Source: KPMG'S Individual Income Tax and Social Security Rate Survey 2009.

Figure 1: Total tax wedge on labour for a single person (as a % of average earnings), 2009²



Source: OECD Taxing Wages 2009

1.3 Review the R&D tax credit

Ensuring that the benefits of the R&D tax credit for foreign owned companies can be reflected in investment appraisals would enhance the competitiveness of an Irish plant's R&D proposal and help increase the volume of R&D activity taking place here without changing the incentives offered. The NCC welcomes recent developments to progress this but further action is required to ensure the R&D tax credit can be taken 'above the line' for all companies³.

1.4 Improve the competitiveness of domestic sectors

While increasing exports will not provide a panacea for all the challenges facing the Irish economy, improving Ireland's attractiveness as a location to do business and export from will be important for restoring the levels of confidence necessary to halt the decline in domestic consumption and investment seen since 2008. Improving the competitiveness of the domestic economy will also be critical for our future economic prospects - its costs impinge on the exporting sectors and its recovery is essential to reduce unemployment and create jobs. Policy certainty (e.g. budgetary decisions on income taxes) and the full delivery of the agreed public capital investment plan are particularly important to supporting large domestically trading sectors such as retail/wholesale and construction.

² OECD average is weighted and based on OECD-28 (excludes Turkey and Mexico).

³ 'Above-the-profit-line' means allocating the 'credit' received directly against costs incurred. Currently, the R&D tax credit which is set against overall corporation tax is 'below the profit line' and it is contended that it is not factored into the evaluation of R&D proposals in instances where corporate decisions are made based on costs 'above the profit line'. Clarity in relation to the treatment of the R&D tax credit under the Irish and International Accounting Standards was obtained following the issue of an information note by Chartered Accountants Ireland last year. Further work is required to remove the impediments to showing the benefit of the R&D tax credit 'above-the-line' under US Accounting standards.

2. Raising revenues

Given the scale of the budget deficit, it is inevitable that taxes will have to increase in the forthcoming budget. Increasing taxes are necessary to reduce the scale of Government borrowing while supporting current and capital expenditure. The recommendations below follow the principles that underpin the OECD hierarchy of taxation (see appendix).

2.1 Broaden the tax base by introducing a value based property tax on residences

Broadening the tax base is central to repairing the public finances. In the absence of measures to broaden the tax base, taxes on income will inevitably have to rise further in the future. Higher taxes on income act as a disincentive to people from remaining in or returning to the labour market. The NCC has consistently recommended replacing stamp duty on property with a broadly based tax on the value of residential properties. Unlike increases in income tax, a recurring residential property tax does not act as a disincentive to economic activity. It can also support more investment by local authorities in their areas. While the proposals in Budget 2010 to progress the introduction of a site valuation tax for non-agricultural land are a welcome development, it will take a considerable length of time to put such a scheme in place. We believe that a significant yield from residential property taxation needs to be secured as a matter of urgency and that this is best done by introducing a value based annual tax on residences.

2.2 Introduce user charges to reflect the costs of services provided

The introduction of a carbon tax in Budget 2010 and the proposal to introduce water charges for domestic users are necessary developments. Further and alternative methods of raising revenue should also be considered, including charges for the users of other services (e.g. third level fees, roads).

- **Third level fees:** Adequate funding is essential to enable Irish higher education institutions to achieve excellence and to equip Irish students with the highest quality of education available. Graduates, who will benefit significantly from higher education in terms of increased earnings over the course of their life, should contribute a portion of the cost of their education. However, it would be important to ensure that such a measure does not act as a barrier to participation in third level, for example, through the introduction of a comprehensive student loan and adequate maintenance grant system;
- **Other user charges:** In order to maintain front line services and capital investment in infrastructure to support the knowledge economy, serious consideration needs to be given to part-financing them through user chargers such as water charges and additional road tolls. A flat rate charge for treated water should be introduced in advance of the rollout of metering and volumetric charging.

3. Reconfiguring expenditure to underpin economic growth

The Government deficit remains extremely large despite steps taken to date. While the NCC does not offer a view on the timing and scale of public expenditure cuts, containing our public debt levels is critical to ensuring fiscal stability and supporting ongoing investment in economic and social infrastructure (e.g. transport, environmental and ICT infrastructure, education, research and health) which enhance our national competitiveness. We also need to protect those on low incomes and social welfare benefits while ensuring that incentives to remain in or return to the labour market exist.

3.1 Eliminate tax expenditures that do not support the productive sector

Tax expenditures (exemptions) in the income tax system are far higher in Ireland than the EU average⁴. We need to remove outstanding tax expenditures where the cost-benefit justification is not clear. In particular, tax incentives that promote investment in property and construction over investment in the productive sector should be withdrawn. Retaining the exemption for patent royalties is an important measure to promote R&D activity in Ireland.

3.2 Review local authority charges

Although many local authorities are in a difficult financial situation, it is critical that local authority charges on businesses are transparent and reflect the true economic cost of serving their needs. Alternative methods of raising revenue (as highlighted above) must be implemented - e.g. in introduction of a residential property tax and the extension of charges for treated water to domestic users. Reform is also required. Careful consideration needs to be given to the recommendations of the Local Government Efficiency Review Group⁵ (which outlined indicative savings of over €500 million annually) and the Limerick Local Government Committee⁶ to deliver greater efficiencies and to reduce charges to business.

3.3 Promote e-payments

Despite having an advanced electronic payment infrastructure, Ireland is highly reliant on cash for payments. In 2008, the value of cash withdrawals at ATMs as a percentage of GDP was 15.8 per cent in Ireland compared to 9.5 per cent in the euro area-16⁷. Ireland is the second most extensive user of cheques in the EU - in 2008, Ireland used 26.4 cheques per capita compared to an EU average of 11.9 cheques per capita⁸. Electronic and card payments are far more efficient than cash and cheques in terms of transaction costs and may limit opportunities for tax evasion. According to a recent study, annual savings of around €1 billion could be made if we switched from cash and cheques to electronic systems⁹. In addition, cash is much less secure and vulnerable to counterfeiting. The NCC recommends the following actions to promote a swift move to e-payments:

- Set a date for the introduction of changes to incentivise e-payment usage (e.g. phasing out cheques);
- Remove the stamp duty on debit and credit cards and increase stamp duties on cheques - according to the Irish Payment Service Organisation (IPSO), Ireland is the only EU country where cards are subject to Government stamp duty¹⁰; and
- Ensure all government transactions are payable via electronic funds transfer.

4 OECD, Economic Surveys: Ireland, November 2009.

5 The report of the group is available at: <http://www.environ.ie/en/PublicationsDocuments/FileDownload,23533,en.pdf>

6 The Limerick Local Government Committee was established by the Minister for the Environment, Heritage and Local Government to prepare a report on the most appropriate arrangements for local government for the City and County of Limerick. The report is available at <http://www.environ.ie/en/LocalGovernment/BoundaryCommittees/PublicationsDocuments/FileDownload,23938,en.pdf>

7 See Figure 5.39 in NCC, Benchmarking Ireland's Performance, July 2010.

8 Irish Payment Service Organisation (IPSO), IPSO 2009 Annual Review, July 2010.

9 National Irish Bank, Target 2013: Modernising Payments in Ireland, September 2010.

10 See IPSO website: <http://www.ipso.ie/?action=statistics§ionName=EUStatistics&statisticCode=EU&statisticRef=EU05#print>

4. Improving policy and delivery

4.1 Improve the fiscal planning framework

There is a need for better fiscal planning and control mechanisms with in-built risk assessment and risk management capacity, once the economy gets back onto a sustainable growth path. Both the OECD and the IMF have proposed changes to the current budget framework. Given the scale of fiscal consolidation required in Ireland, the IMF recommends institutionalising commitments to stabilise the public finances¹¹. The OECD also outlined the need to create a budget framework with the rules and institutions to protect the budget against outcomes where revenues are spent even when they are transitory¹². Structures of this type already exist in countries such as Sweden and the UK has recently established an Office for Budget Responsibility¹³. Serious consideration now needs to be given to how Ireland can reform its fiscal policy framework to ensure sustainable and stable public finances in the future.

5. Conclusion

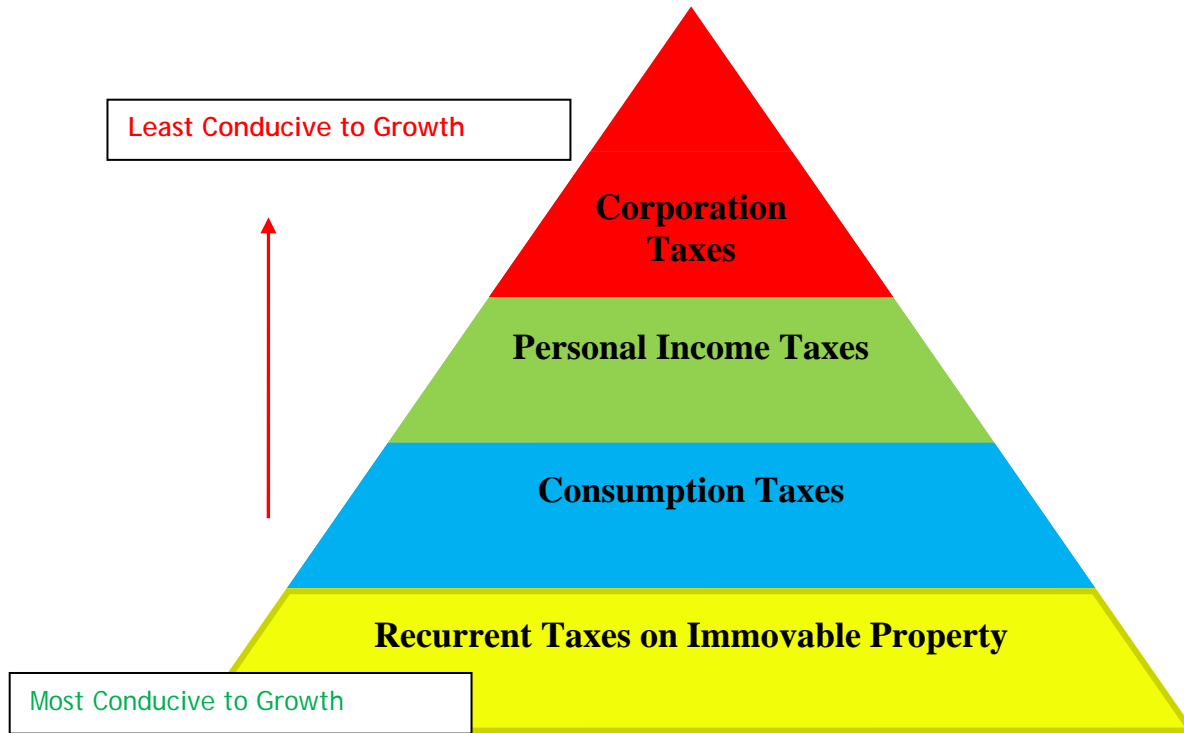
While the Irish economy has contracted very considerably in the past two years, we continue to have significant competitiveness strengths and opportunities. Exporting sectors are already contributing positively to economic performance. Ensuring that actions to repair the public finances are consistent with our competitiveness objectives is critical.

11 International Monetary Fund, Ireland - Concluding Statement for the 2010 Article IV Consultation, May 2010.

12 OECD, Economic Surveys: Ireland, November 2009.

13 For details of the UK Office for Budget Responsibility, see http://www.hm-treasury.gov.uk/data_obr_index.htm

Annex 1- OECD Hierarchy of Taxation



Source: OECD (2008), *Taxation and Economic Growth*, OECD Economics Department Working Papers, No. 620

Wilton Park House, Wilton Place,
Dublin 2, Ireland

Tel +353 1 607 3000

Fax +353 1 607 3030

www.forfas.ie



National
Competitiveness
Council

