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POLICY BRIEF:
Economic Equality Series

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A Third Rate of Income Tax

Introducing a third rate of income tax would make the tax system more equitable, while allowing government to improve public services, or fund tax cuts for middle and low incomes earners.

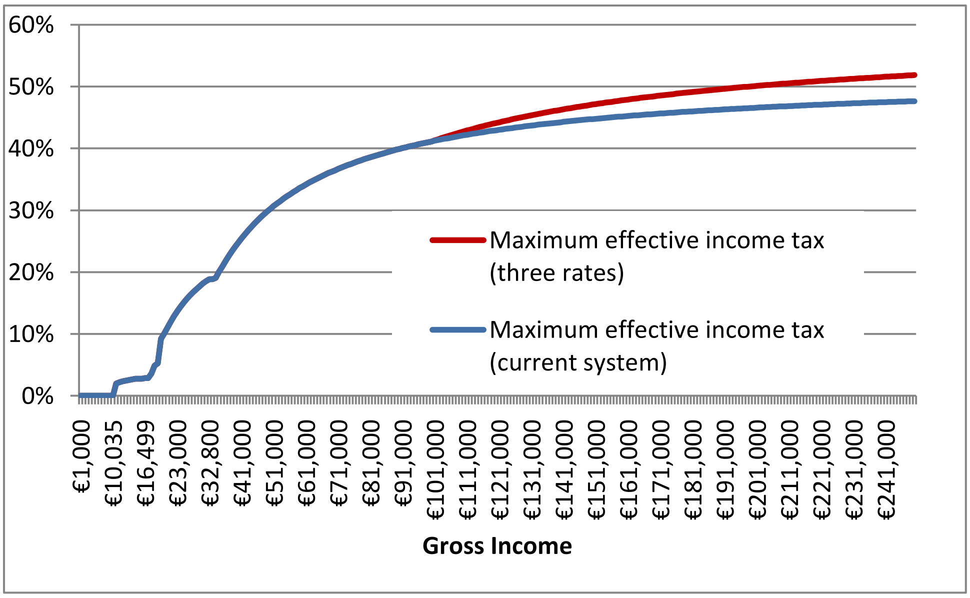

Chart 1: Theoretical 'effective' Income Tax Rates – current two-rate system v. adding a third rate (including USC and PRSI)

It is sometimes argued that Ireland is unusual in having a system where workers begin to pay the highest income tax rate at less than average wage levels. That is, the 41% higher rate is paid on income above €32,800. A person who earns €40,000 is often portrayed as 'paying tax' at the higher rate of 41%.

However for a person on €40,000, the maximum income tax payable according to the rules is only 15.5%.

Similarly, they are only liable for a maximum of 24.8% if USC and PRSI are also included, far less than the '52%' marginal rate (see Chart 1).

Income Tax in Ireland

Income tax makes up 42 per cent of the Government's tax revenue and is paid by 38 per cent of the adult population or 1.4 million adults. This rises to 44 per cent or 1.6 million adults if USC is included.

Income tax interacts with a number of key elements of the economy: employment, wages and consumption.

Income tax paid in Ireland is lower than the 'headline' rates suggest. The average rate of income tax paid in Ireland is just below 14% of gross income for households. The amount paid ranges from zero for the lowest earners up to an average of 23% for the top 10 per cent of income earners.

There are also a number of other unusual features of the Irish income tax system. Firstly, Ireland has very high level of tax credits, tax reliefs and tax breaks available.

The use of tax breaks by many people can lower the actual amount of tax paid to below the theoretical maximum. The theoretical rates, as illustrated in the chart, are sometimes called the 'effective' tax rate but do not take these tax reliefs into account.

Secondly, Ireland is highly unusual for its very low level of PRSI, especially employers' social security contributions; which are effectively the lowest level of social insurance in the EU.

Only Two Rates

Ireland's income tax system has also the relatively uncommon feature of only having two rates (20% and 41%) rather than more rates and bands.

Two-thirds (65 per cent) of income tax payers do not pay any income tax at the higher rate, and 85 per cent pay less than a quarter of their gross income at the higher rate (see Chart 2).

Conversely, only 6 per cent of income tax payers pay are liable for the higher rate on more than half of their gross incomes.

Introducing a further higher rate on earnings above €100,000 would only impact on 5 per cent of those who currently pay income tax.

Declining Progressivity

The result of these interactions in Ireland is a smooth progression of theoretical effective income tax payable as incomes rise, which begins to taper off as people start to earn more (see Chart 1).

Although there is progressivity in the Irish income tax system, in that the proportion income tax paid increases as income rises, this progressivity begins to decline on higher incomes because there are only two rates.

The point of decline begins at around €70,000 which is roughly around twice the average wage. At this point, the progressive increase of income tax as a percentage of actual tax paid rises more slowly.

Previous Rates in Ireland

Historically, Ireland had more than two tax rates as set out in Table 1. At the same time as the number and rate of income taxation has declined, Ireland has also seen a rise in gross incomes.

This is not to imply a direct relationship, as gross income is determined by market incomes, not just taxation.

However, seeing the combination of two is instructive. Not only were gross incomes on the rise (despite the prolonged recession of the 1980s) but decreases in income tax were likely to have benefitted high earners disproportionately compared to the rest of society.

As gross incomes for high earners rose and taxes on high incomes were reduced, inequality in Ireland also rose (see Chart 3).

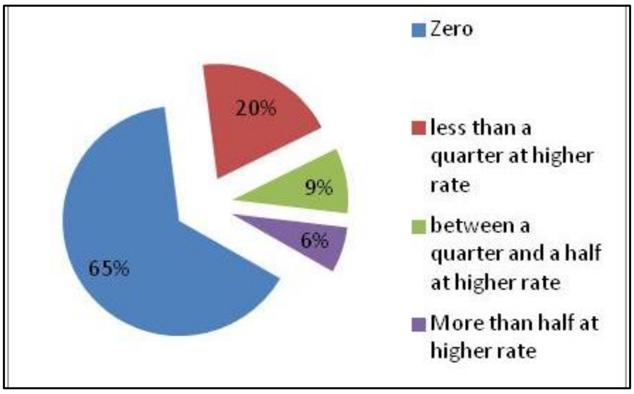

Chart 2: Percentage of people and the amount of higher rate tax they pay

Rising Inequality

Charts 3 illustrates the disproportionate rise of higher incomes above average income growth in real terms.

In percentage terms, the share of income of the top tenth of income earners grew from 28 per cent of all income in 1975 to 36 per cent in 2009. Similarly, the top one per cent nearly doubled their share of income, from six per cent in 1975 to over 10 per cent in 2009.

The trend of growing inequality is likely to be similar in relation to the share of wealth in Ireland, with even higher concentrations at the top.

In the context of growing income and wealth inequality in Ireland (and elsewhere), taxes on high incomes have an increasingly important role to play to avoid further deepening social divisions.

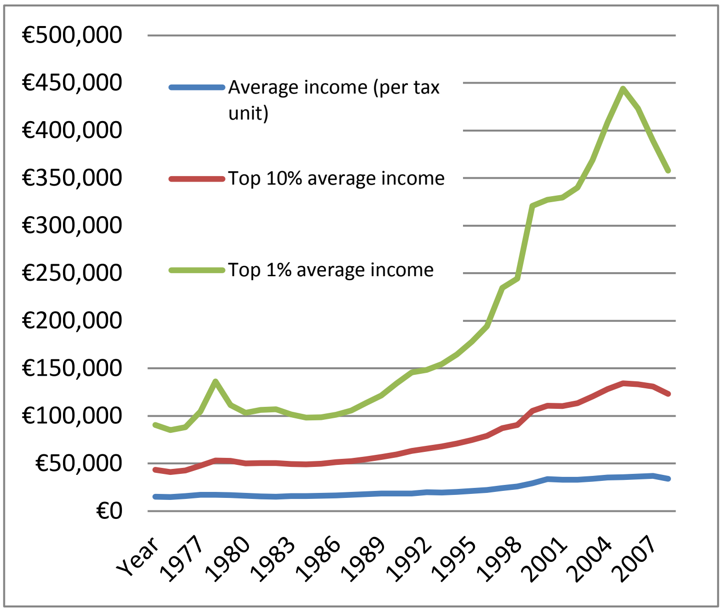

Chart 3: Rising income inequality in Ireland

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Year	Number of rates	Intervals	Gross income share of top 10%	Gross income share of top 1%
1977	6 rates	20%, 25%, 35%, 45%, 50% and 60%	27.3%	5.6%
1979	5 rates	25%, 35%, 45%, 50% and 60%	31.3%	8.0%
1983	6 rates	25%, 35%, 45%, 50%, 60% and 65%	33.3%	7.1%
1984	5 rates	35%, 45%, 55%, 60% and 65%	31.6%	6.5%
1985	3 rates	35%, 48% and 60%	31.3%	6.3%
1989	3 rates	32%, 48% and 56%	30.5%	6.4%
1992	2 rates	27% and 48%	34.0%	7.8%
2014	2 rates	20% and 41%	36.1% (2009)	10.5% (2009)

Table 1: Historical tax rates in Ireland relative to gross income shares

Improving the Tax System

Introducing a third rate of income tax would give a more equitable distribution of income, while increasing progressivity and flexibility.

The historical data shows a real opportunity to introduce a third rate of income tax to be applied on the portion of taxable incomes in excess of €100,000, without altering the existing income tax rates or bands.

Impact

The effect of a third rate, set at 48% on incomes above €100,000, is also illustrated in Chart 1 (front page).

It would have no impact on earnings below €100,000, involve a steady increase in effective rates between €100,000 and €200,000 and a much slower increase on gross incomes above that level.

It would affect just under 100,000 people, which is less than 5 per cent of all those paying income tax.

The Revenue Commissioners estimate the full year yield to the Exchequer, by reference to 2013 incomes, of the introduction of the new income tax rates of 48%, 49% or 50% would be of the order of €365 million, €415 million and €470 million respectively.

Effect on Employment

A top marginal rate of 58% (including USC and PRSI) on high incomes may be considered too high for a 'headline' rate, with a resulting negative impact on investment decisions.

However, investment decisions are driven by more than just headline rates, and Ireland is very competitive in Europe when all aspects of wages and taxation are considered. The actual amount of tax payable – even by high earners – is relatively low and employer's PRSI is much lower (for lower overall labour costs).

An alternative to a third rate of income tax would be to increase employer's PRSI on incomes over €100,000. This could raise a similar amount of money without impacting on the headline rate.

Conclusion

The introduction of higher rates of income tax on high gross incomes is almost certainly necessary to stem the rise of income inequality in Ireland. It has been proposed by a number of political parties and by the Irish Congress of Trade Unions.

Introducing a third rate of income tax on high incomes (above €100,000) at 48%, would generate much needed income for public services, and would prevent those on average incomes paying the highest rates. Importantly, it would also improve the real progressivity of the overall tax system. A third rate would affect just under 100,000 income tax payers, while raising €365 million.

Introducing such a change in Budget 2015 would provide the Government with one source of funds to allow tax cuts in other areas or improve public service provision without undermining the sustainability of the national finances.

Given the stark picture of rising income inequality in Ireland, a return to higher income tax rates on the small minority of very high income earners must be seriously contemplated.

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Primary Reference

This briefing paper is based on:

Nat O'Connor, Cormac Staunton and Paul Sweeney (May 2014)*"A Defence of Taxation"*, TASC.

Available to download on the TASC website: http://www.tasc.ie/publications/tasc-a-defence-of-taxation/

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Data from Deloitte Tax Calculator, with additional calculations by the authors http://www.deloitte.ie/tc/

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