

PRSI Refund Scheme for Low Paid Workers

A proposal to fix an inequitable 'step effect' in PRSI affecting low paid workers. It shouldn't cost an employer €1,680 to give a one euro net pay raise, yet it sometimes does!

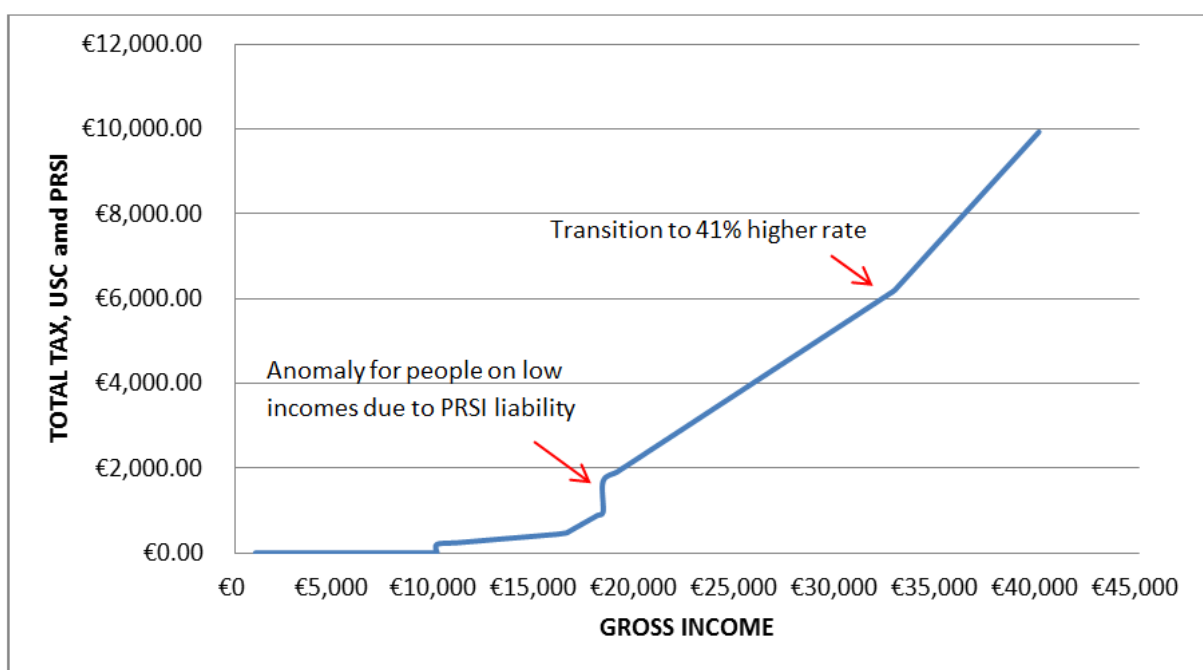


Chart 1: Effective Tax Rates including Income Tax, USC and PRSI payable on Wages up to €45,000¹

The inequitable 'step effect'

As the above chart of effective tax rates illustrates, there is currently a 'step effect' in personal income taxation, which affects people on low incomes.

Under the current system, anyone earning below €10,000 pays no tax at all (from income tax, USC or PRSI), while someone earning above €10,000 begins to pay a small effective rate of tax. For example, someone with gross pay of €11,000, will pay an effective rate of 2% tax (from USC), which increases to an effective rate of 4.9% by the time he or she earns €18,000.

However, while someone earning €18,304 pays an effective tax rate of 5.25%, someone who is paid one euro more will pay an effective tax of 9.25%, due to the onset of PRSI. This has the perverse consequence that a person earning €18,000 has higher net pay than someone earning €19,000. The figures are given in Table 1 and plotted in Chart 2.

While this exempts many part-time and low-paid workers from PRSI, the anomaly occurs because once someone is earning slightly more than the minimum wage full-time, he or she begins to pay PRSI on all earnings.

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Gross Pay	USC	Income Tax	PRSI	Net Pay	% Effective Tax
€18,000	€579	€300	€0	€17,121	4.89%
€18,304	€600	€361	€0	€17,343	5.25%
€18,305	€600	€361	€732	€16,612	9.25%
€19,000	€649	€500	€760	€17,091	10.05%
€19,366	€674	€573	€775	€17,344	10.29%
€20,000	€719	€700	€800	€17,781	11.10%

Table 1: Gross pay versus net pay between €18,304 and €19,366

Looking at this in more detail, the anomaly persists between wages of €18,304 and €19,365. Only at €19,366 is a person's net pay higher (by one euro) than it would be at €18,304. As it stands, it effectively means that someone on close to the minimum wage needs a gross pay rise of over €1,000 to achieve any increase in their take-home pay. This is a disincentive to employers to increase wages, or for employees to accept extra hours of work.

There is also a risk that this situation encourages cash payments 'under the table' to work around the flaw in the system. This is not an argument against PRSI or other taxes on low income workers, but the anomaly is unjust and should be removed through technical changes to the operation of the tax system for those on the income levels affected by the step change.

With the current policy focus on increasing employment, and ensuring that work always pays better than welfare, it would make sense to remove this anomaly.

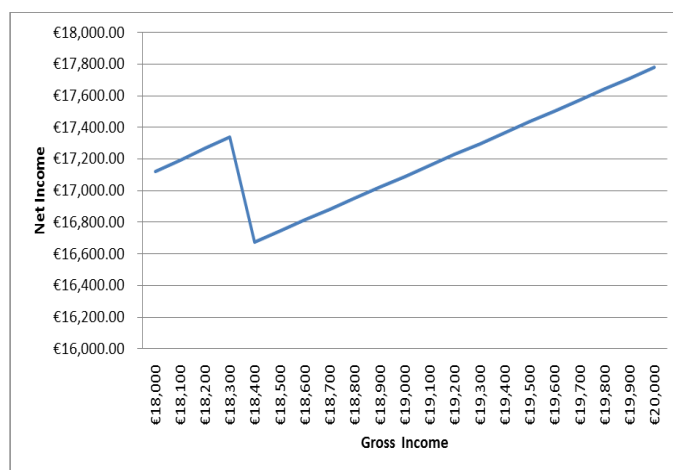
Employer's PRSI

The disincentive to employers to pay higher wages is further compounded by the fact that the employer's contribution to PRSI changes from 8.5% to 10.75% on all earnings above €18,512, creating a further step effect.

Gross Pay	USC	Income Tax	PRSI (employee)	Net Pay	PRSI (employer)	Total labour cost
€18,000	€579	€300	€0	€17,121	€1,440	€19,440
€18,304	€600	€361	€0	€17,343	€1,464	€19,768
€18,305	€600	€361	€732	€16,612	€1,464	€19,769
€18,512	€615	€402	€740	€16,754	€1,481	€19,993
€18,513	€615	€403	€741	€16,755	€1,990	€20,503
€19,000	€649	€500	€760	€17,091	€2,043	€21,043
€19,366	€674	€573	€775	€17,344	€2,082	€21,448
€20,000	€719	€700	€800	€17,781	€2,150	€22,150

Table 2: The employer's cost to give a worker on €18,304 just one euro extra net pay is €1,680

Chart 2: Change in net pay (blue line) as gross pay increases



Continuing with the example of someone on low gross annual pay of €18,304, not only does gross pay need to be raised by €1,062 before he or she receives one euro extra in net pay, but additional employer's PRSI must be paid too. This means that an employer must pay a total additional of €1,680 to give an employee in this position one euro extra take-home pay in his or her annual wages. This undermines the ability of SME employers to provide better wages to their staff and to use small wage increases or overtime as an incentive. This is shown in Table 2.

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Numbers of people affected

In the context where 20.7 per cent of workers in Ireland are classified by the EU as 'low paid' (earning less than €12.20 per hour)² and given that many workers may not be getting full-time work sufficient to bring them outside of this anomaly in the tax system, this should not be seen as an isolated issue affecting only small numbers of people.

This point is reinforced by Revenue data on the income distribution among tax units³. They report 85,966 single men and women with gross incomes between €17,000 and €20,000 as well as 36,637 couples or widows/widowers. Although the latter have different income tax credits, the anomalous step change in PRSI remains the same. This represents 122,603 tax units (151,038 people) within the tight gross income band of €17,000 to €20,000 who are potentially affected by this issue, as well as those (many part-time) workers earning less than €17,000 who have this road block on their earnings horizon. In stark contrast, the much discussed transition from the standard rate of income tax (20%) to the higher rate (41%) produces no such anomaly.

Possible Solution: PRSI Refund Scheme for Low Income Households

The main reason for the extreme nature of the 'step effect' is that PRSI is payable on a person's entire income once he or she passes the threshold. The only way to remove this kind of step effect is to remove this feature from the tax system. Ideally, this should be achieved without major loss of revenue for the social insurance fund, as the PRSI 'step effect' may be costly to fix.

As we have seen in revenue data there are 122,603 tax units with gross income of between €17,000-20,000. Assuming each paid an average of €750 in PRSI, they would contribute nearly €92 million to the social insurance fund every year. However, this is unlikely to be the case. If we assume half of the €17,000-20,000 group earn less than €18,304, they will currently not pay any PRSI (the mid-point in this income group is €18,500, nearly exactly the point where the anomaly occurs). Assuming the other half make an average PRSI contribution of €750, the social insurance fund would gain €46 million every year from this cohort.

Hence, €46 million is an estimate of the maximum cost of fixing the step effect; however, as shown below, it can be fixed for around half of that cost.

In order to keep the cost of adjustment down, the solution must be contained within this income group. Simply exempting the first €18,000 from PRSI, and beginning payments at €18,100, would benefit almost all income tax payers and prove much more costly in terms of lost social insurance revenue. A full 'refund' would simply move the step effect further up the income distribution, which is not a solution. To contain the cost, the refund solution should be targeted only at the affected low income cohort.

A modified solution therefore is to provide the refund by tapering the PRSI contributions made between €18,304 and €20,300. Tax payers (units) on gross income of €20,300 would continue to pay €812 in PRSI, as at present. However PRSI for someone on €18,400 would be reduced from €736 to €40.60, with an additional increase of €40.60 for every €100 of additional earnings.

We estimate that this would benefit half of the group of 122,603 tax units. The total amount of refunds required under this proposal would be less than under a complete refund scheme. The overall effect would be to lessen the step effect within the affected income group, at around half the cost of a full refund (circa €23 million).

The advantage of this solution is that the step effect is entirely removed. The disadvantage is that, while theoretically simple, this would require a new administrative process to be established, in parallel to the standard system and standard rates of employee PRSI. However, this would be no more onerous than the previously existing PRSI 'disregard' system in terms of paperwork for affected employers or changes to payroll software. Specifically, employers would calculate employees' PRSI liability as normal (at 4%), but starting at €18,400. Those employees earning a gross annual income of between €18,400 and €20,300 would be entitled to claim some of that PRSI back as a refund – see Table 3 below. Given the preponderance of part-time and temporary work in this income group, a monthly scheme might be more appropriate than asking employees to wait for an annual refund.

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Alternatively an annual refund could be complemented by a 'hardship scheme' where people who need the refund sooner could make a special application to have the funds released earlier. The final column in Table 3 shows the refund as a percentage of the taxpayer's annual net income, which helps convey the financial importance of this step effect anomaly to those affected.

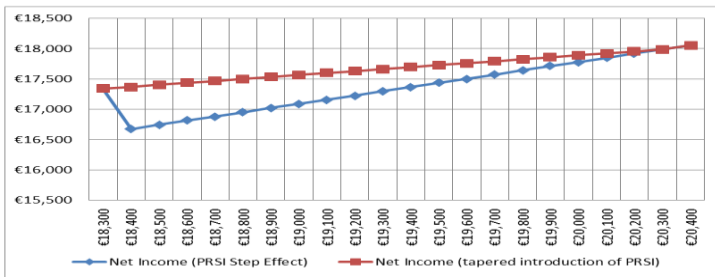


Chart 4: PRSI Step Effect versus Tapering Introduction of PRSI on Low Earners

Endnotes

- ¹ Calculated from the Deloitte Tax calculator <http://www.deloitte.ie/tc/> and verified using payroll software.
- ² NERI (2013) Quarterly Economic Observer December 2013 http://www.nerinstitute.net/download/pdf/neri_geo_december_2013.pdf
- ³ Revenue Commissioners (2012) – Income Distribution Statistics <http://www.revenue.ie/en/about/publications/statistical/archive/2011/income-distribution-statistics.pdf>

Gross Income	PRSI liability (current 4%)	Net Income (current)	PRSI to be paid by employee	PRSI Low Income Refund	Net Income (proposed)	Refund as % net income
€18,000	€0.00	€17,120.50	€0.00	€0.00	€17,120.50	0.0%
€18,100	€0.00	€17,193.50	€0.00	€0.00	€17,193.50	0.0%
€18,200	€0.00	€17,266.50	€0.00	€0.00	€17,266.50	0.0%
€18,300	€0.00	€17,339.50	€0.00	€0.00	€17,339.50	0.0%
€18,304	€0.00	€17,342.42	€0.00	€0.00	€17,342.42	0.0%
€18,305	€732.20	€16,610.95	€0.00	€0.00	€17,342.65	0.0%
€18,400	€736.00	€16,676.50	€40.60	€695.40	€17,371.90	4.0%
€18,500	€740.00	€16,745.50	€81.20	€658.80	€17,404.30	3.8%
€18,600	€744.00	€16,814.50	€121.80	€622.20	€17,436.70	3.6%
€18,700	€748.00	€16,883.50	€162.40	€585.60	€17,469.10	3.4%
€18,800	€752.00	€16,952.50	€203.00	€549.00	€17,501.50	3.1%
€18,900	€756.00	€17,021.50	€243.60	€512.40	€17,533.90	2.9%
€19,000	€760.00	€17,090.50	€284.20	€475.80	€17,566.30	2.7%
€19,100	€764.00	€17,159.50	€324.80	€439.20	€17,598.70	2.5%
€19,200	€768.00	€17,228.50	€365.40	€402.60	€17,631.10	2.3%
€19,300	€772.00	€17,297.50	€406.00	€366.00	€17,663.50	2.1%
€19,400	€776.00	€17,366.50	€446.60	€329.40	€17,695.90	1.9%
€19,500	€780.00	€17,435.50	€487.20	€292.80	€17,728.30	1.7%
€19,600	€784.00	€17,504.50	€527.80	€256.20	€17,760.70	1.4%
€19,700	€788.00	€17,573.50	€568.40	€219.60	€17,793.10	1.2%
€19,800	€792.00	€17,642.50	€609.00	€183.00	€17,825.50	1.0%
€19,900	€796.00	€17,711.50	€649.60	€146.40	€17,857.90	0.8%
€20,000	€800.00	€17,780.50	€690.20	€109.80	€17,890.30	0.6%
€20,100	€804.00	€17,849.50	€730.80	€73.20	€17,922.70	0.4%
€20,200	€808.00	€17,918.50	€771.40	€36.60	€17,955.10	0.2%
€20,300	€812.00	€17,987.50	€812.00	€0.00	€17,987.50	0.0%

Table 3: Detail of Proposed PRSI Refund Scheme for Low Income Tax Units



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