Tax and Welfare Policy: Indexation and Benchmarks for Distributional Impact

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Overview

- Role of default policies for tax and welfare uprating
- What benchmark for assessing distributional impact?
- Indexing the system as a whole: indirect taxes and non-cash benefits
- Selected issues in welfare indexation
- Cost and distributional impact of indexation choices – Budget 2020

Default policy: *Variation across countries*
Example: Mandatory earnings-related pensions

Period	Uprating policy
No automatic indexation	Austria
Price indexation	Belgium, Canada, France, Hungary, Iceland, Italy, Korea, Poland, Turkey, USA
Price and wage indexation e.g., weighted average	Czech Rep, Estonia, Finland, Greece, Japan, Latvia, Lux'brg, Portugal, Slovak Rep, Switzerland
Wage indexation	Germany*, Netherlands*, Norway, Slovenia, Sweden
*= conditional on fiscal sustainability	

Default policy: *Variation over time*

Example: UK Basic State Pension

Period	Uprating policy
1948-1974	Yearly decisions, no uprating rule
1975-1980	Higher of wage growth and price inflation
1980-2002	Price inflation
2003-2010	Higher of 2.5% and price inflation
2011-	"Triple lock": highest of earnings growth, price inflation or 2.5%

Default policy: *Variation across benefits*

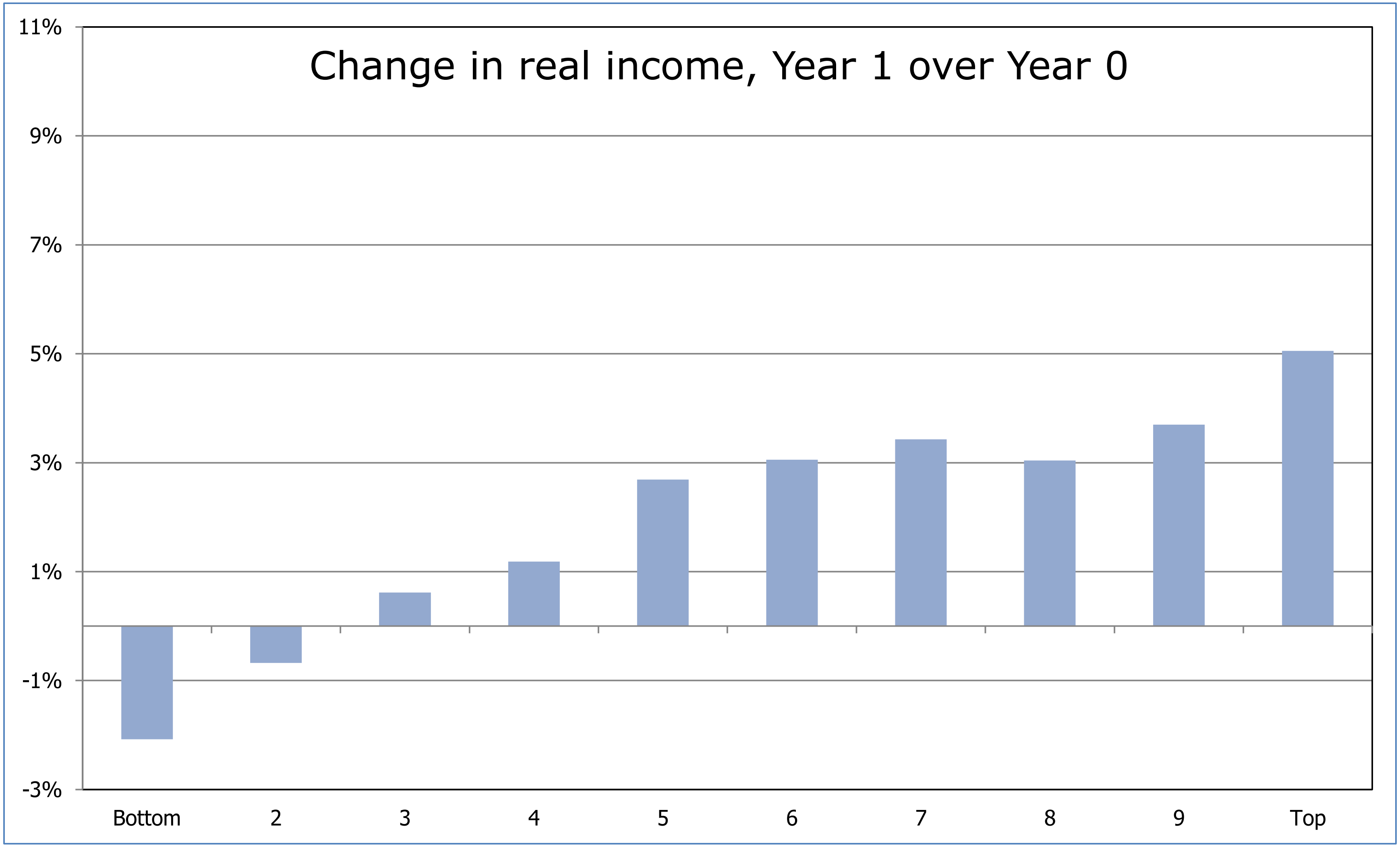
Example: UK State Pension

Pension policy component	Uprating policy
Basic State Pension	"Triple lock": highest of earnings growth, price inflation or 2.5%
Additional State Pension	Price indexation (CPI)
Minimum guarantee to Pension Credit	Wage indexation
Saving Credit component of Pension Credit	"As the Secretary of State sees fit"

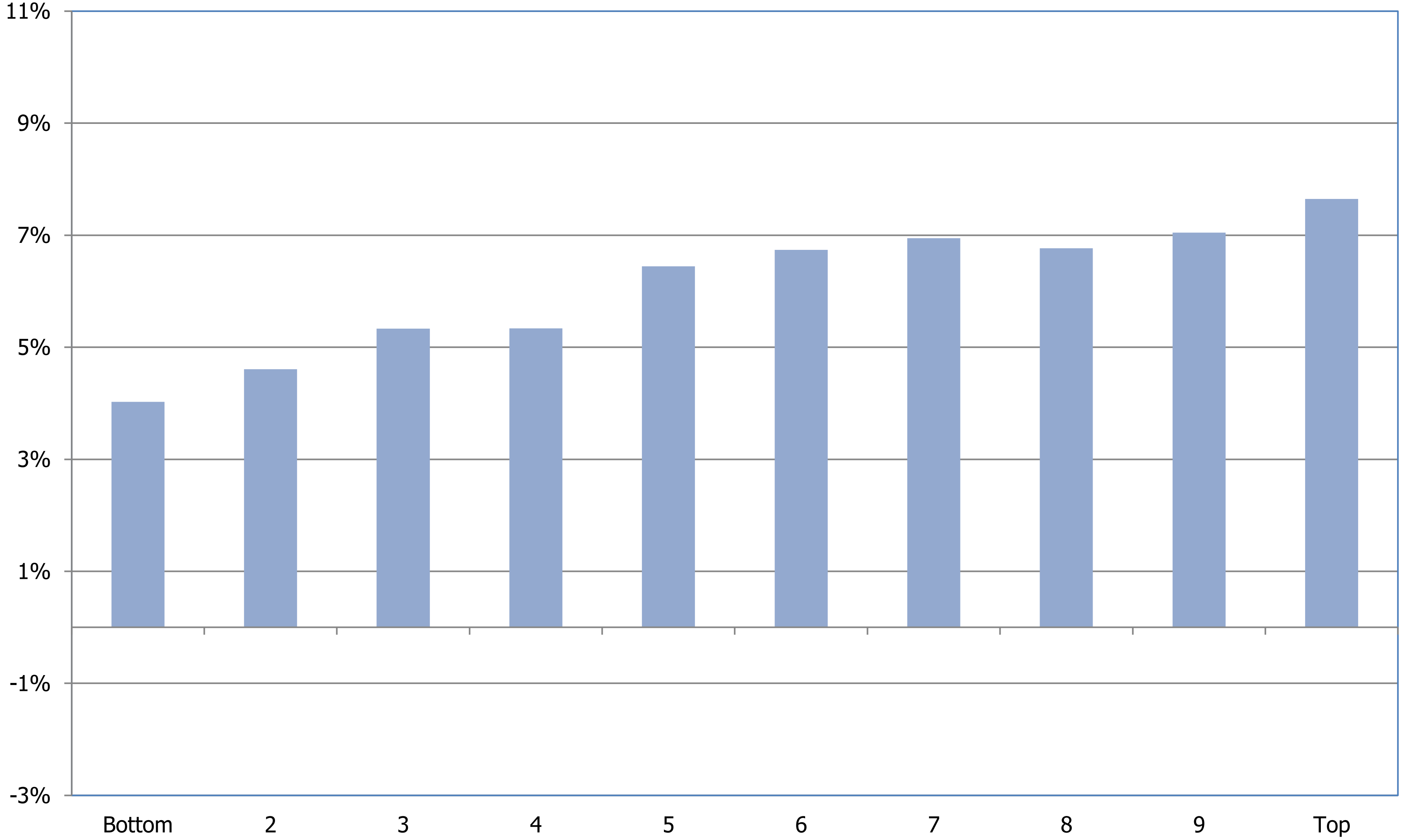
Illustrative scenario

- Price inflation: 2% per annum
- Real income growth: 2% per annum
- Over 5 years
  - Nominal incomes rise by almost 22%
  - Real incomes rise by 10.5%
- Local Property Tax
  - Technical assumption: Property tax revenue rises in line with incomes (but relative bills relate to current property values)

Distributional implications of a nominal freeze (non-indexation)



Distributional implications of price indexation of tax/transfer policy



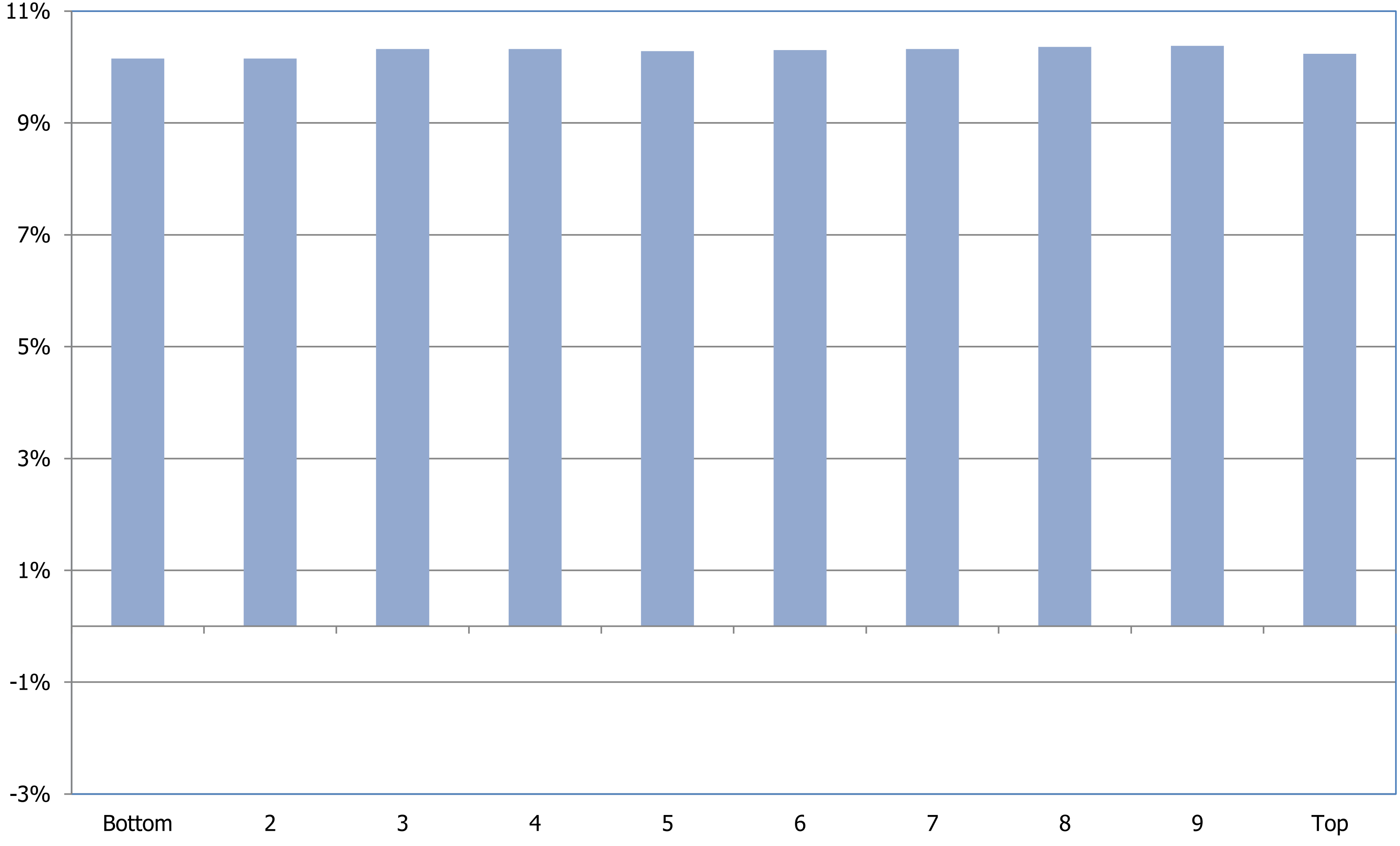
Recap

- Fiscal drag
  - If income tax bands and credits do not rise in line with incomes, average income tax rates rise
- Benefit erosion
  - If welfare payment rates are not increased in line with incomes
    - Welfare incomes fall behind average incomes
    - Income shares of low income deciles fall

Choice of benchmark

- Default policy as benchmark?
  - Varies over time, across countries, across benefits/taxes
  - Could be “gamed” by governments
- An independent benchmark
  - Price inflation
    - Constant real values, but not neutral in distributional or macro terms
  - Wage/income growth
    - Neutral in distributional and macro terms

Distributional implications of wage/income indexation



IMPACT OF ALTERNATIVE BENCHMARK POLICIES ON KEY INDICATORS

	Indexed in line with prices, or frozen in nominal terms	Indexed in line with wages/incomes
Government spending as share of national income	Decrease	Constant
Income tax as % of national income	Increase	Constant
Exchequer balance moves towards surplus (+) or deficit (-)	Lower deficit/higher surplus	Constant
Distributional impact	Increased inequality, greater rise in real income for high incomes than for low incomes	Neutral, same rise in real income across all income deciles
Increase/decrease in "at risk of poverty" rate	Increase	Constant

Recent EU outcomes: total policy effects

Country	Real growth in market income 2001-2011	Impact of policy changes, relative to wage indexation, on Gini	Impact of policy changes, relative to wage indexation, on poverty (AROP)
Belgium	0	−0.6*	−1.6*
Bulgaria	61	1.4*	−0.8
Estonia	57	−1.1*	−3.6*
Greece	1	−0.6*	−0.6‡
Hungary	14	2.3*	2.9*
Italy	-3	−1.1*	−1.2*
UK	11	−1.3*	−3.4*

Recap: Some implications

- For a clear picture of the income distribution consequences of a given policy, we need to use a neutral benchmark – wage/income indexation

- **IF** government wishes to ensure that income inequality does not increase, tax and welfare parameters must increase in line with wage/income growth

Balance Between Benefits

- Strong focus in policy circles on state pensions – 34% of average industrial earnings (Pensions Board 1998); 34% of average earnings (Pensions Roadmap 2018).

PAYMENT RATES FOR JOBSEEKERS BENEFIT AND STATE CONTRIBUTORY PENSION, SELECTED YEARS, 1982-2019			
	Jobseeker's Benefit	State Contributory Pension	"Pensioner premium"
	€ p w	€ p w	%
1982	40.19	51.11	27.2
1987	53.71	69.96	30.3
1994	77.45	90.15	16.4
2000	98.40	121.89	23.9
2007	185.80	209.30	12.6
2014	188.00	230.30	22.5
2019	203.00	248.30	22.3

- Ministerial remarks – Jan 2019: under a new index-linked welfare system, “payments won’t drastically increase, but they are not going to drastically decrease”.

Indexation of the System as a Whole

- Direct taxes and cash benefits considered up to now.
- Indirect taxes.
- Income cut-off levels for (non-cash) benefits.

Indirect Taxes

- Indirect taxes calculated either as % of price of a good (e.g. VAT) will naturally rise as prices rise.
- Indirect taxes charged by quantity at a nominal rate will not e.g. tobacco/alcohol products tax, carbon tax.
- ‘Fiscal boost’ will occur i.e. real fall in such taxes as price rise.
- Current default policy in nominal, indirect taxes – no automatic adjustment, ad hoc changes.
- Indexation in line with prices seems a natural option here.

Income Cut-offs for Benefits

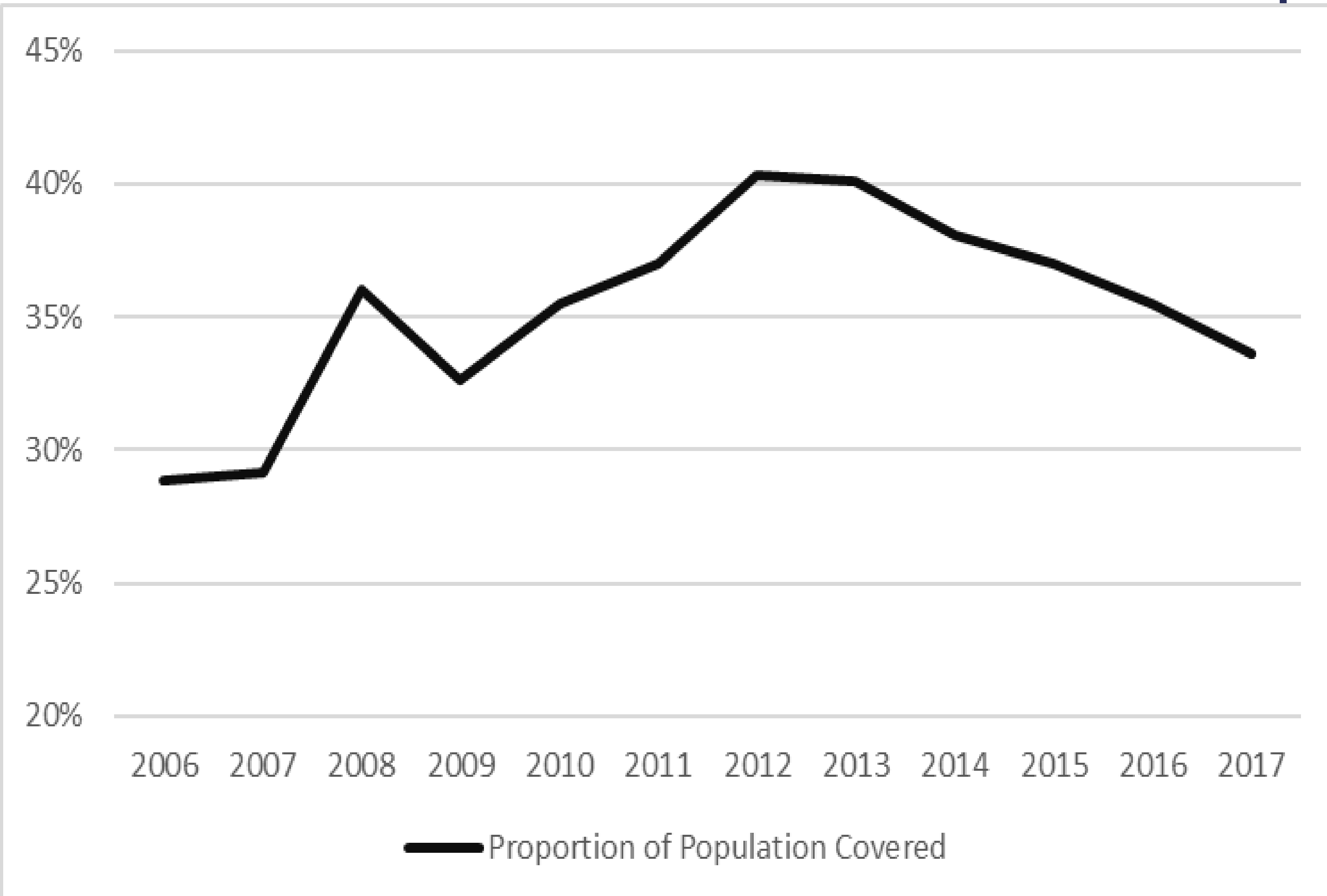
- Failure to index the income limits for means tested (non-cash) benefits will result in fewer individuals being eligible for such benefits as earnings and cash benefits rise.
- Examples include income limits for the ACS subsidies; income limits for housing benefits; Medical/GP-Visit Cards.
- Income limits for the Medical Card have remained unchanged since 2006.

Medical and GP-Visit Cards

- *"Budget 2019 provided for increases in a number of social welfare payments which are intended to come into effect in March 2019. It would be the Government's intention that people's ability to qualify for a medical card would not be adversely affected by this increase. I have asked the HSE to monitor the situation and to advise me if it considers that changes in the rates of social welfare payments may affect people's ability to qualify for a medical card."*

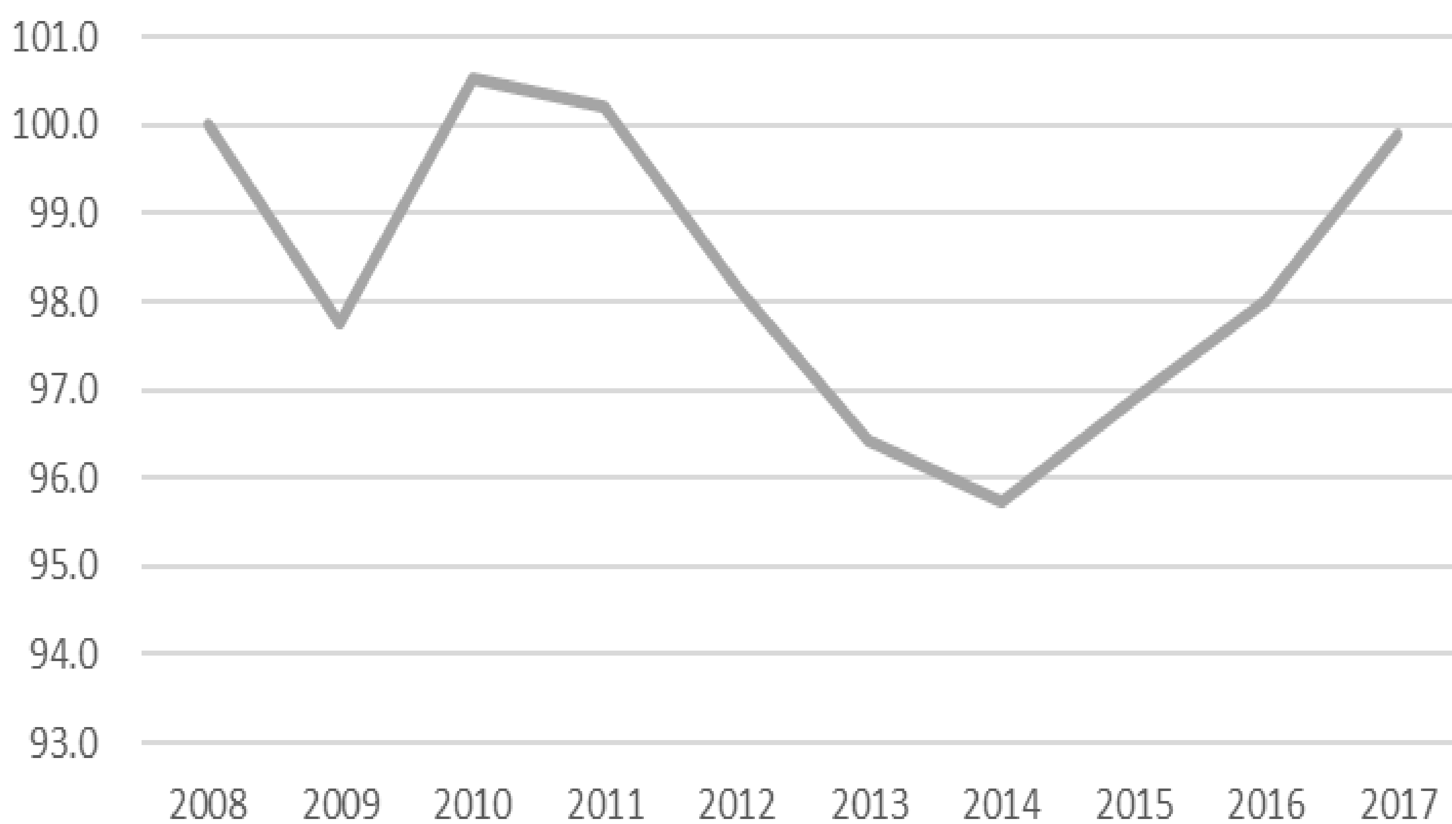
(Minister of Health, January 22nd 2019).

Medical Cardholders As A Proportion of the Population



Cyclical Variations – smoothing & ratcheting

Index of Real Average Earnings, 2008-2017



Cyclical Variations – smoothing & ratcheting

- Is it possible to "smooth" the path of welfare payments when average incomes are falling?
- Will lead to ratcheting - welfare payments rise at a faster rate than both wages and prices in the long run.
- Welfare payments must on average follow average incomes, so if protected during downturn, they must be less than the full extent of growth in upturns to avoid a ratcheting effect.
- Public finance consideration.
- Care needs to be taken to distinguish between cyclical falls and shifts in long term trends.

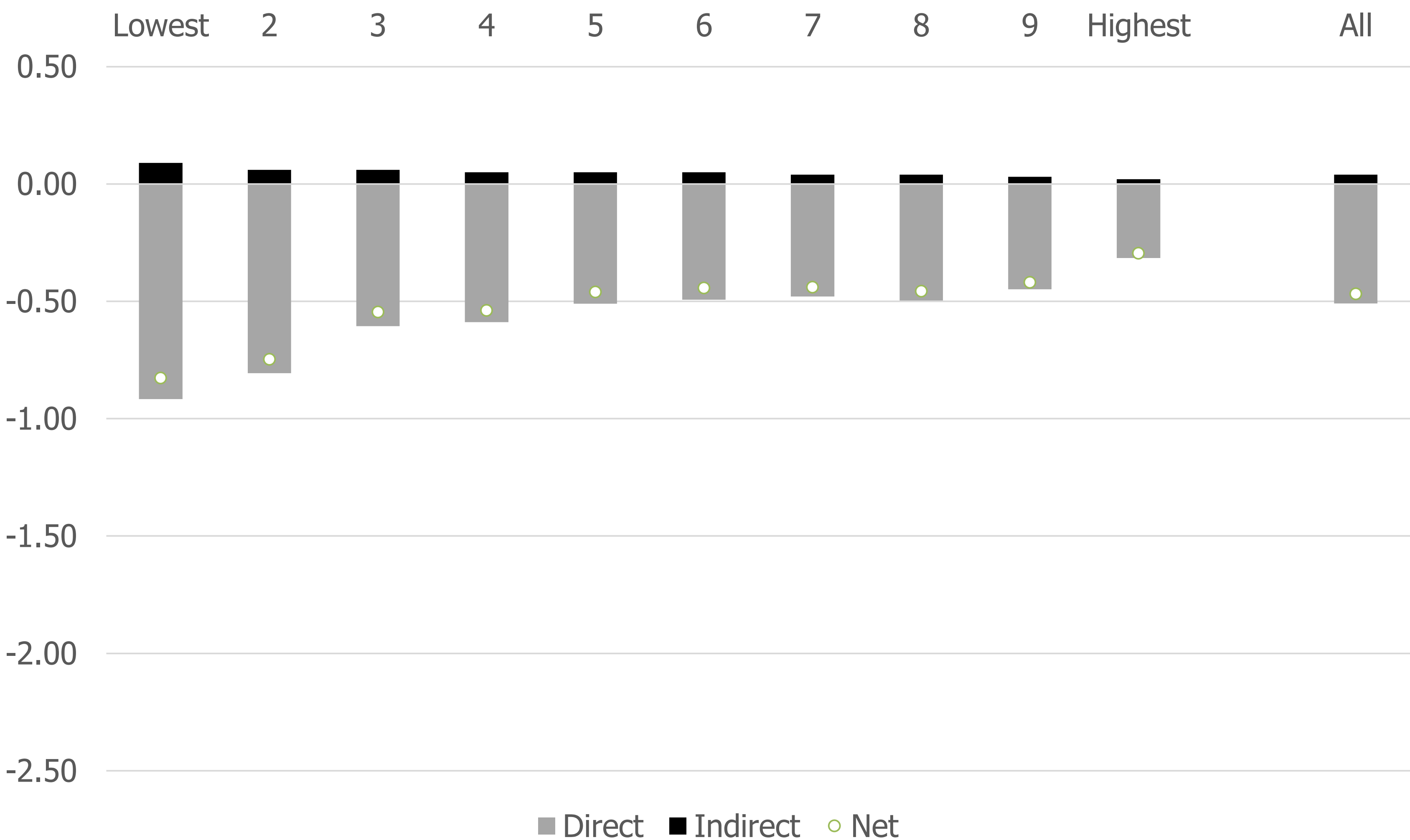
Cost of Indexation –Budget 2020

- Indexation of the direct tax and benefit system will cost the exchequer.
- Indexation of the indirect tax system will generate revenue for the exchequer.
- 2 scenarios examined:
  1. Indexation of direct/indirect taxes and benefits by price inflation estimate.
  2. Indexation of direct taxes and benefits by wage inflation estimate; indirect taxes by price inflation estimate.

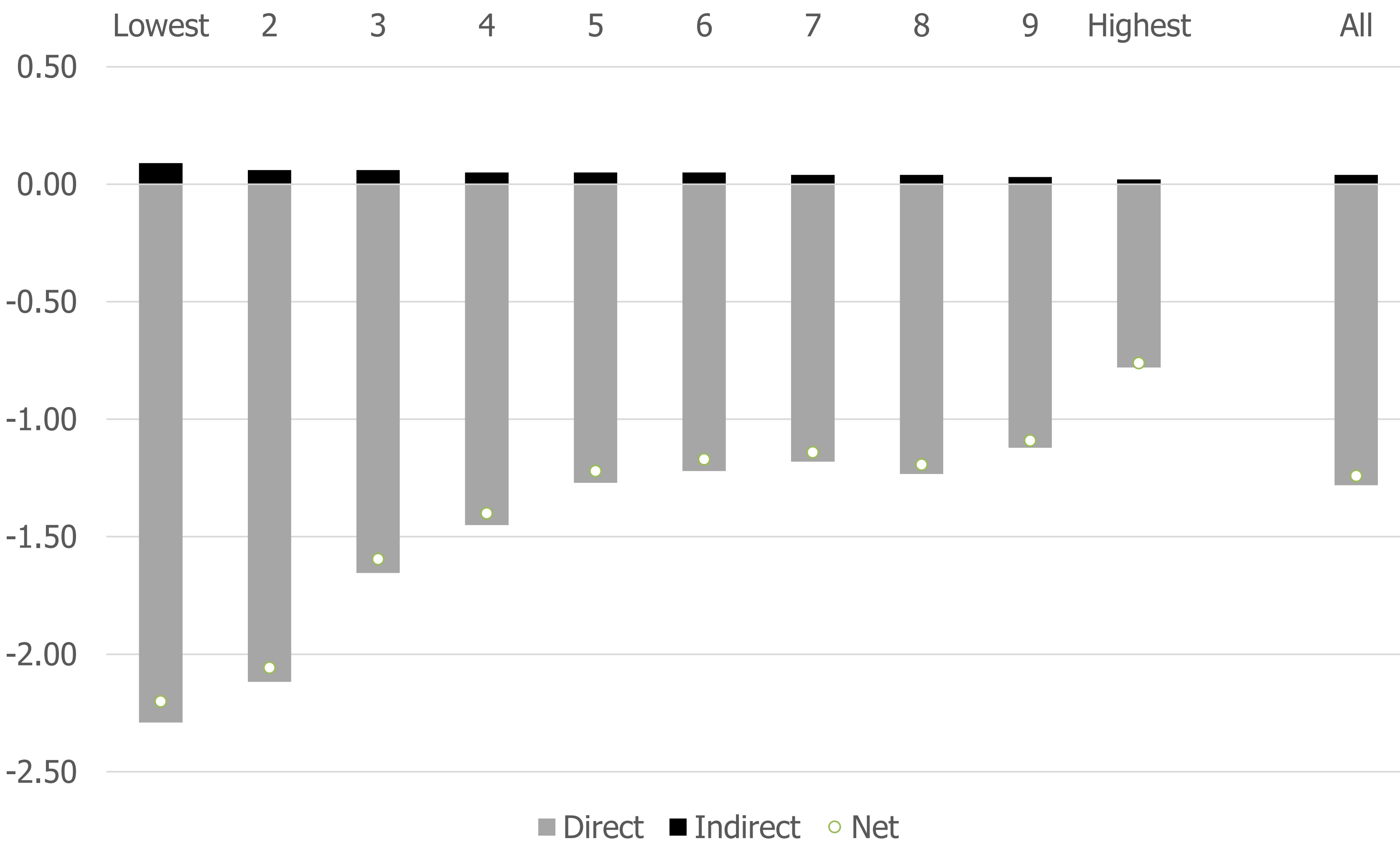
Cost of Indexation –Budget 2020

	CPI indexation; Direct /Indirect Taxes & Benefits	Wage Indexation; Direct Taxes/Benefits. CPI Indexation: Indirect Taxes
	€m p.a.	€m p.a.
Indexation exchequer cost, direct taxes/benefits	499.8	1,265.9
Indexation exchequer gain, indirect taxes	37.8	37.8
Net exchequer cost of indexation	**462.0**	**1,228.0**

Distributional Impact of non-Indexation : Scenario 1



Distributional Impact of non-Indexation: Scenario 2



Conclusions

- Wide variation on indexation policy across countries/time/taxes & benefits.
- Irish tax bands/credits & welfare rates have tended to keep pace with earnings growth.
- Implications of (non) indexation for exchequer revenue as well as inequality & poverty:
  - Non-indexation and price indexation lead to a rise in inequality & poverty as well as a rise in tax & a fall in expenditure:GNP ratios in the longer run.
  - Wage indexation results in constant poverty/inequality indices and constant tax & expenditure:GNP ratios in the longer run.

Conclusions

- It is important to consider the system as a whole: indirect taxes, income limits for benefits etc.
- For Budget 2020 price indexation would cost €462m; wage indexation (with price indexation for indirect taxes) would cost €1.2bn.
- These costs need to bear in mind the fiscal space available.
- Failure to index will result in a regressive pattern relative to an indexed benchmark.

Thank You.

Comments and questions are welcome