# Statement to the Committee on Budgetary Oversight; February 2nd, 2022


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Let me begin by thanking the Chair for the invitation to the ESRI to appear before the Committee. I am Dr. Claire Keane, I am joined by my colleague Dr. Karina Doorley, and we work in the area of taxation, welfare and pensions research at the ESRI. We are happy to provide our views on indexing the tax and welfare system and will focus on the rationale for indexation, how such a system could be created as well as the economic sustainability of such a system.

## 1 Rationale for indexation

Indexation, or changing the monetary parameters of the tax and welfare system in line with price or earnings changes, is often suggested as a useful policy tool, both nationally and internationally. Currently, the Irish tax and benefit system is not automatically indexed. Instead, discretionary changes to tax and welfare parameters are announced, usually at Budget time. Historically, these changes have, on average, kept pace with earnings growth (Callan et al, 2018[1]) although on a year-to-year basis, there can be some deviation (Roantree et al, 2021).[2]

The absence of a rule for increasing welfare payments, tax credits and bands in line with inflation or earnings growth has implications for household purchasing power, the exchequer, poverty and income inequality. Consider a year in which price growth is 2% and earnings growth, which is usually higher, is 4%. If all tax and welfare parameters are frozen, the

[1] https://www.esri.ie/publications/income-growth-and-income-distribution-a-long-run-view-of-irish-experience
[2] https://www.esri.ie/system/files/publications/QEC2021WIN_SA_Roantree.pdf

purchasing power of those receiving welfare falls and income taxpayers face paying more of their income in taxes, a situation known as fiscal drag. The exchequer experiences an increase in income in real terms due to this fiscal drag. People may also lose eligibility to cash and non-cash benefits (such as Medical Cards, housing subsidies, childcare subsidies and student grants) due to earnings growth. Income inequality tends to increase as the incomes of those dependent on welfare falls relative to workers.

If tax and welfare parameters increase in line with price growth, the purchasing power of those receiving welfare is constant, exchequer revenue from income tax still increases in real terms (as tax credits and bands fail to keep pace with wage growth) and income inequality increases, albeit by less than in the case of no indexation.

Only by indexing tax and welfare parameters in line with wage growth do welfare recipients and workers see their income grow at the same rate. This wage indexation scenario is distributionally neutral which keeps at-risk of poverty rates and income inequality constant.

## 2 Creation and Operation of an indexation system

The creation of an indexation system first requires the identification of a benchmark i.e. what a desirable or adequate level of welfare benefits should be. Once the benchmark has been reached, further increases can continue to be linked to the benchmark or be linked to a price or earnings index.

Previous expert groups have suggested benchmarks for the Irish welfare system. The report of the Social Welfare Benchmarking and Indexation Group (2001)[3] suggested that, if indexation were to be adopted, the lowest welfare rates should be increased to 27% of Gross Average Industrial Earnings.[4] The National Pensions Framework (2010)[5] suggested that the State

[3] OPEA15.pdf (esri.ie)

[4] Given the decline in the importance of industry in the Irish economy, the relevant metric today might be average weekly earnings

[5] national_pensions_framework.pdf (pensionsauthority.ie)

Pension should be benchmarked at 35% of average weekly earnings to prevent elderly poverty with the Roadmap for Pensions Reform 2018-2023 (2018)[6] suggesting a similar benchmark.

In terms of which index to use, Callan et al (2019) argue that the natural index for indirect taxation is prices to ensure that taxes set at a fixed rate per unit of a commodity, such as excise duties and the carbon tax, remain constant in real terms. However, indexation based on earnings growth may be more suitable for income tax and welfare parameters if the aim is to avoid poverty or inequality increases. Internationally, there are many examples of indexation systems in operation. Besides very few examples of automatic and unified earnings indexation (e.g. Denmark), the most common practice remains adjustment linked to prices.[7] When uprating is linked to earnings, this is often limited to pension benefits. Indexation of tax bands and credits is much less common in Europe, more commonly seen in the U.S. and Canada.

While typically wages rise by more than prices, they are both subject to cyclical variations and at times indexation with respect to real wages would imply falls in real incomes for welfare recipients. If welfare payments are protected during downturns, they must be increased by less than the full extent of growth in upturns to avoid a 'ratcheting' effect, whereby, social welfare rates would grow faster than either incomes or inflation in the long-term.[8]

## 3 Budgetary Sustainability

Finally, it is important to bear in mind that automatic indexation removes some discretion available to government each year and can reduce the scope for more targeted measures for groups considered to be at greater risk of poverty or deprivation. It can also limit the Government's ability to respond to economic shocks. Callan et al (2019) estimated the net cost of indexing the tax and welfare system in 2020. Indexation would have cost between €462m

[6] https://www.gov.ie/en/publication/abdb6f-a-roadmap-for-pensions-reform-2018-2023/

[7] This type of indexation is in operation in Sweden, Finland, New Zealand and Australia.

[8] An alternative that prevents ratcheting is the 'smoothed earnings approach' whereby benefits are indexed in line with wage inflation unless price inflation is higher, in which case benefits are indexed in line with prices. In subsequent years, where wage growth again exceeds price inflation, welfare rates continue to be indexed in line with price inflation until such time as the earnings benchmark is once again restored.

(price indexation) and €1.3 billion (wage indexation) so between 10%-29% of the available fiscal space of €4.5 billion that year.

In summary, indexation, or a lack thereof, has implications for poverty and inequality. While price indexation of the tax and welfare system would ensure that inflation doesn't erode purchasing power it would still result in an increase in poverty rates and inequality. Indexation in line with earnings growth would avoid increases in poverty and inequality but generally comes at a higher cost for the exchequer. Both indexation options reduce budgetary flexibility. The decision to index the tax-welfare system is, therefore, ultimately a political one but could be assisted by using a microsimulation model, such as the ESRI's SWITCH model, which could be used to estimate, in advance, the cost of indexation options each year to assess their financial feasibility.