Pre-Budget Submission from The Iona Institute

A critique of tax individualisation and a proposal for reform

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Summary

- Tax individualisation deals with people primarily as individuals and not as members of households with possible dependents.

- Favourable treatment of two-income households unfairly increases the pressure on parents of young children to be in paid employment, rather than care for children at home.

- For example, a married couple who each earn €40,000 and have no dependents pay tax at the standard rate on €65,600 of their combined income. Meanwhile, a married worker supporting five people (self, a spouse at home and three children) starts to pay the higher rate tax at €41,800.

- The home carer tax credit is presently less than half the PAYE tax credit

- In a time of high unemployment, incentivising two-income households will inevitably increase the number of households with no income and at risk of poverty.

Overall, financial policies affecting families should seek to support families rather than concentrating on maximising employment.

Recommendations

- The gap between the home carer tax credit and the PAYE tax credit could be partially or completely closed, without net loss or gain of revenue, by a slight reduction in the PAYE tax credit and slight increase in the amount of the home carer tax credit.

- Similarly, the €65,600 standard rate band for two-income couples and the corresponding €32,800 band for single people could be slightly reduced, with a corresponding small increase in the cut-off for one-income married couples. This would be financially neutral overall, minimise impact on low-income families in particular, and begin to move towards a more equitable system.

- The home carer tax credit should also take account of the number of dependents when financially possible.

- The standard rate cut-off for married couples should be adjusted upwards for those with dependents, as is the case for single or widowed parents, as soon as financially possible.

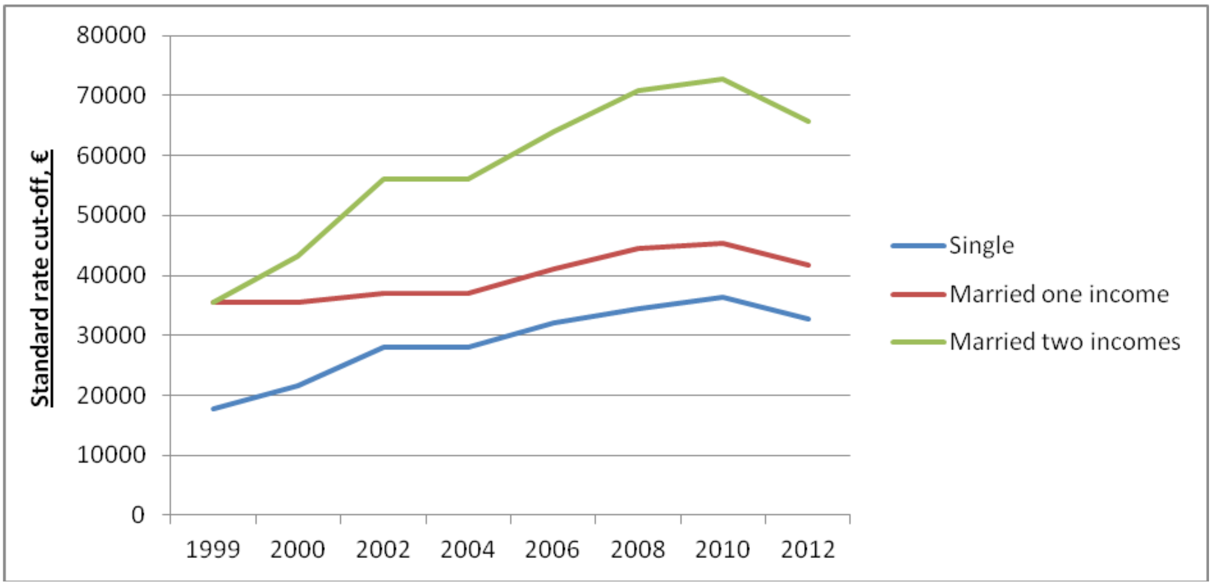
- Similarly, personal tax credits should be allocated for dependent children of married couples, as is the case for single or widowed parents.

1. Background

The policy of tax individualisation was introduced to great public controversy by Charlie McCreevy as the Fianna Fail Minister for Finance in 2000. The minister wanted to ease the tax burden on single people but was concerned that the cost would be excessive if all married couples continued to receive double the tax allowance of a single person. However, Minister McCreevy also made it clear that his intention was to “encourage more married women to participate in the workforce.”

In 2000, the standard rate cut-off was £17,000 for single incomes, £34,000 for two-income married couples and £28,000 for single-income married couples. Two-income couples could earn £6,000 more than one-income couples before paying the higher rate of tax.

Over the next decade, the standard rate cut-off for two-income couples increased faster than for other groups. By 2010, two-income couples could earn €27,400 more than one-income couples before paying the higher rate of tax (Figure 1), and thus pay €5,754 less tax on the same gross income.



By now, the pendulum has swung from a financial incentive against two-income households, to an equally substantial incentive against single-income households. This has a particular impact on families with young children, leaving both parents under financial pressure to be in paid employment and leave children in daycare despite the finding of an opinion poll by

Amárach Research in July 2013 that just 17% believed a crèche was the preferred option for caring for children under five.[1]

Having gradually arrived at a stage when two-income couples have all of €23,800 more of their income taxed at the standard rate compared to one-income couples, this gulf needs to be bridged, but no easy solution exists. To reduce the €65,600 cut-off for two-income married couples or civil partners while leaving the cut-off for single people as it is, would create a financial penalty for marriage, which would also be bad policy. To increase the €41,800 cut-off for one-income couples would cost money. To reduce the cut-off for both two-income couples and single people proportionately would be difficult in a time of austerity.

Three options remain for re-balancing the situation.

- Gradually, but substantially, increase the single-income married couple cut-off, balanced by small reductions in the figures for two-income married couples and single taxpayers.

- Increase home carer tax credits gradually but substantially. This and the previous option would take many years to achieve an equitable system.

- Reform the basis of the tax system to deal with households rather than individuals.

In Germany[2] and France[3], the tax policy deals with people as members of a household, rather than as individuals, a concept which takes account of the demands on a person's salary and the number of people depending on it. In France, children generally receive 50% of the adult personal tax allowance and families have a pooled allowance. In Germany, parents receive a €7,000 tax-free allowance per child. This approach is much more relevant to the social and financial reality that people live in, rather than being detached "individuals."

2. Social impact of tax individualisation

In 2007, the Iona Institute produced a paper by barrister John Paul Byrne, criticising the effects of the increasing degree of tax individualisation. The foreword was written by the then Labour spokesperson on finance in opposition, and now Minister for Social Protection, Joan Burton. Her comments are worth quoting again:

> "Small wonder that during the early years, many such families opt for one spouse, usually the mum, to stay at home as a full time carer.
> Should such a decision be penalised as heavily as it now is by the State? Parents should be
> encouraged to spend more time with their children and with each other. It is a legitimate social policy for any State to encourage long term stable and loving relationships in which children are cared for.
> Across the tax and social welfare code, there is now a significant anti-family bias that is worrying.

[1]Iona Institute (2013) press release. http://www.mediacontact.ie/mediahq/ionainstitute/57921/press-release-from-the-iona-institute-new-poll-finds-only-17pc-of-people-believe-day-care-is-best-option-for-children.html

[2] http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/JDCN-89HSEY

[3] http://www.kpmg.com/global/en/issuesandinsights/articlespublications/taxation-international-executives/france/pages/income-tax.aspx

> The tax individualisation penalty of up to €6,240 plus per annum is a very high price to pay for one parent caring for the children full time in the home."

As Minister Burton pointed out less than ten years ago, tax individualisation creates serious issues for social policy. The family model of single income couples where a parent cares for his or her own children at home should be supported or at the very least not penalised as it now is.

Victoria White expressed it well in the Irish Examiner recently when she suggested that "our societies should be calibrated for one job per household."[4] However, she acknowledged that it would take years to move towards this from our present individualised system, with the economy effectively treating a two-income system as the norm which in turn helps to make it the norm through incentive effects. There is something wrong with a society where parents caring for their own young children in the home are likely to experience economic hardship as a result.

Creating substantial incentives or rewards for having two incomes per household rather than one is also economically inappropriate in a time of high unemployment. From a household point of view, let's consider the options: two incomes, one income and no income. Clearly there are many more workers and would-be workers than jobs. So if this tax policy is succeeding in making single-income couples into dual-income couples, it will have the inevitable side-effect of leaving more households with no job. For society overall this can only be detrimental for poverty rates.

During the property boom many couples, hoping to set up a stable home of a reasonable size for their families, took out mortgages which would be difficult or impossible to pay on one income, unless a reasonably high single income. Some have taken pay cuts and others have lost a well-paid job and been unable to find a similar one. Such couples are faced with the choice of both parents being forced to work outside the home or else lose their home, even if the mother (or father) would prefer to care for their children full-time. In contrast, Article 41.2 of the Constitution calls on the State to try to ensure that mothers should not be "obliged by economic necessity" to work outside the home. While an amendment to include both parents in the wording of the article would be welcome, the principle behind it is reasonable. For the State to leave tax individualisation in its present form, in the current social and economic context, is contrary to the spirit of Article 41.2.

The constitution explicitly recognizes the value to society of work in the home. However, money talks, and tells us loud and clear in many ways that economic activity is more valuable than family life. This needs to change.

3. **Summary of financial factors affecting one- or two-income families**

<u>Factors acting to the advantage of two-income compared to one-income couples include:</u>

a. Total gross income

b. Tax band structure

[4] Irish Examiner, 22 August 2013. "We need to stop tax system incentivising dual income familes." http://www.irishexaminer.com/opinion/columnists/victoria-white/we-need-to-stop-tax-system-incentivising-dual-income-families-240622.html

c. Tax credits

d. Employer pension and PRSI

e. Long-term earning potential

a. For the sake of clarity it is relevant to state the obvious that total gross income is likely to be higher with two incomes than one. This is offset to some extent by more tax but still an advantage (see point (f) below).

b. Dual income married couples have a higher standard rate tax band than single income married couples, so they pay up to €5,000 less tax per year for the same total household income.

c. Dual income households benefit by having two PAYE tax credits worth €1,650 each, compared to one PAYE tax credit and one home carer tax credit worth €810, creating a benefit of €840 per annum for having two incomes.

d. Employees generally receive employer pension contributions and PRSI contributions and two people in the household receiving these benefits is financially better than one.

e. While not a formal policy, it is a natural consequence in the labour market that a person who gives up paid employment for a period of time to care for young children is to some extent likely to reduce their long-term earning potential, compared to otherwise similar peers who stayed in the workforce.

<u>Factors acting to the advantage of single-income compared to dual-income couples include:</u>

f. Total tax, PRSI and USC

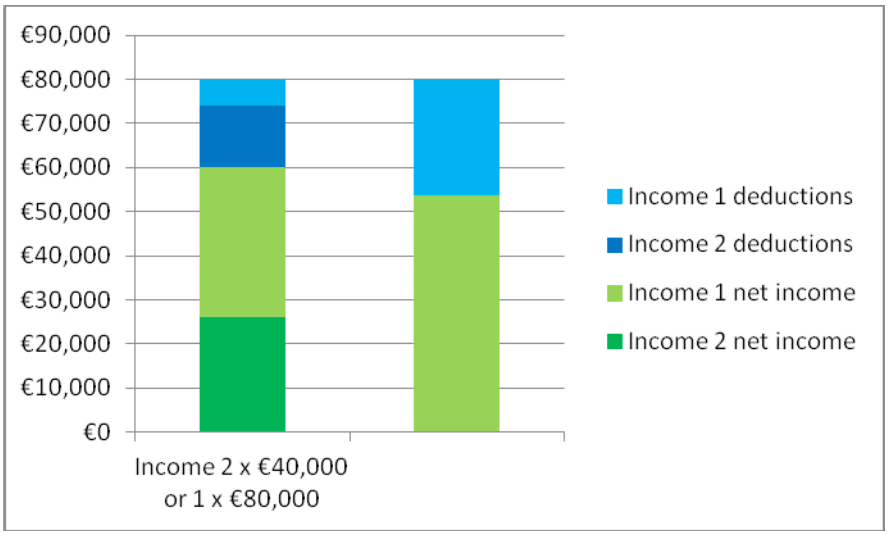
g. Childcare costs

h. Working lifestyle costs (transport, clothes, food)

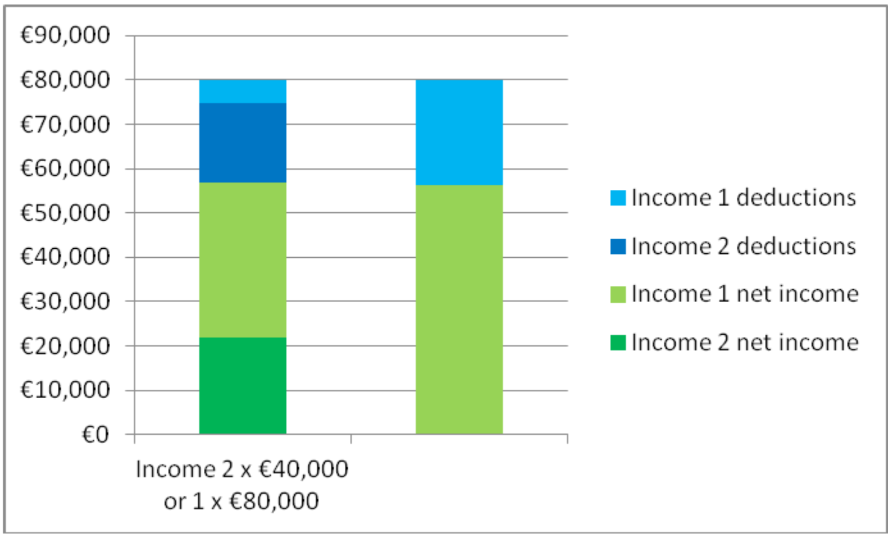
f. Obviously households with two incomes of, say, €30,000 each pay more net tax than one income of €30,000. However, having two incomes rather than one will lead to a similar or greater amount gained in additional take-home pay than the amount lost in additional deductions (PAYE, PRSI and USC).

At present these deductions will not exceed 50% of a second income, up to at least a joint income of €400,000. Without tax individualisation, joint incomes between approximately €100,000 and €200,000 would be subject to deductions between 50% and 52%.

For example, a couple each earning €40,000 presently have €20,000 in deductions, while a married single income of €80,000 pays deductions of €26,000. On a per household basis, the government collects more tax from the single income household.



Consider the effect of, for example, changing the standard rate cut-off to €50,000 for all married couples and setting a second-income tax credit equal to the home carer tax credit. The government collects the same amount of tax from these two households, but it is now distributed more equitably.



g. A survey earlier this year reported an average cost of €162 per week for a child in a creche across Ireland.[5] For two children, this comes to almost €17,000 per year. However, a recent ESRI publication found just a quarter of children aged 3 were mainly cared for in daycare settings, while half of three-year-olds were cared for by parents.[6] Many parents of school-age children work part-time during school hours without incurring childcare expenses.

The assumption that most or all dual-income households are paying high childcare costs is not true.

h. Apart from childcare costs, taking up paid employment incurs other costs, such as transport, clothes, and food. These may be greater, up to double the amount, for households with two employees rather than one. An ESRI working paper estimated the average cost of working, accounting for transport, clothes and food, at €6,800 per year, although the ESRI withdrew the paper amid controversy.[7] It can be expected that this figure varies considerably between employees.

Germany accounts for this type of expense in its tax code. Each employee receives a tax-free allowance of €1,000 per year. This allowance is increased if there is documented proof of employment-related expenses above this amount.[8]

Overall, a second income brings financial benefits and also financial costs. The net benefit varies greatly between, for example, low-income workers paying childcare costs and high earners with no significant employment-related costs.

A couple who are each earning €30,000 per year and paying childcare costs as well as other employment-related costs may gain little financially from the second income. A couple who both earn €80,000 with no childcare costs will gain approximately €40,000 from the second income, after PAYE, PRSI, USC and average employment-related costs.

If tax individualisation is based on the assumption that most or all workers incur high employment-related costs, it is likely to be a blunt instrument resulting in a lot of waste. It also ignores the fact that parents who choose to care for a young child at home and give up

[5] Irish Examiner, 26 March 2013. "Childcare 'costs three months of average annual wage.'" http://www.irishexaminer.com/breakingnews/ireland/childcare-costs-three-months-of-average-annual-wage-589219.html
[6] http://www.esri.ie/UserFiles/publications/BKMNEXT243/BKMNEXT243_ES.pdf. Page 19.
[7] Crilly, Pentecost & Tol (2012) "The Cost of Working in Ireland. http://www.rte.ie/news/2012/0612/esri_report.pdf
[8] http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/JDCN-89HSEY

a second income often incur a significant loss of total net household income. With all this in mind, the government's more lenient treatment of two-income households is not justified.

4. Tax arrangements for married couples take no account of dependent children.

It is sometimes argued that a high degree of tax individualisation is still necessary, to offset childcare costs and other costs linked to paid employment. However, the same tax benefits are given to dual income couples whether they have young children in paid childcare, independent adult children, or no children. Meanwhile, one-income married couples are charged tax without taking any account of how many people depend on their income.

Couples earning joint incomes from €65,600 up to €200,000 and beyond, each effectively supporting one person if they have no dependents, pays tax at the standard rate on €65,600 of their income. Meanwhile, a married worker supporting a spouse at home and three children starts to pay higher rate tax at €41,800, taking no account of the fact that he or she is supporting five people. This is not equitable, especially when we consider that other areas of the tax code do take into account whether a taxpayer has dependents.

According to Census 2011, there were 261,652[9] family units consisting of a husband and wife without children. This did not include cohabiting couples or civil partnerships. Some of these will indeed be low-income couples with little to spare. However, others will be earning one or two salaries over €100,000.

In 2009-10, the ESRI Household Budget Survey report said that among households consisting of two adults without children, 34.5%[10] have two incomes. Combining this with the Census 2011 figure leads to an estimated 90,270 married couples without children with two incomes.

The average gross industrial wage was estimated in 2012 at €696 per week or €36,181 per year.

The standard rate cutoff increase for a married couple who are both on the average industrial wage reduces their tax bill by €3,818 per annum.

This leads to a figure of the order of €345 million a year (€3,818 per couple for 90,270 couples) involved in incentivising the dual income arrangement of married couples without children – a blunt instrument which leaves some paying much more or much less tax than a fair system would ask.

On a separate point, single parents receive a tax credit of €1,650, and pay tax at standard rate on €4,000 more of their income, compared to single people without children. There are a variety of welfare benefits available. These supports recognise and alleviate the risk of poverty for one-parent families. Clearly, for example, the likelihood of needing paid childcare (unless relatives are available) to enable parents to take up employment is very different between one-parent families and one-income married couples.

[9] CSO (2012) , Table 14, page 80.

http://www.cso.ie/en/media/csoie/census/documents/census2011pdr/Tables,and,Appendices.pdf

[10] CSO (2012) Household Budget Survey 2009-2010 Volume 2, Table 7, page 191. http://www.cso.ie/en/media/csoie/releasespublications/documents/housing/2010/full.pdf

However, childcare is by no means the only expense to be considered for families with children which reduces their ability to pay tax. The tax code should take account of the various financial demands of both pre-school and school-age children on both single-parent and two-parent families. Accommodation (rent, mortgage, property tax), education (books, uniforms, “voluntary” contributions), health insurance, healthcare, clothing and food are all costly but basic needs.

5. Tax individualisation fails to support low-income workers but benefits high earners.

Families with joint income under €41,800 don’t benefit at all. If the government was truly concerned for poor families struggling with childcare fees, it would be more effective to provide the tax benefit through tax credits (which would benefit all taxpayers), or through more direct subsidies or grants, instead of raising the standard rate cutoff point. The lower the income, the less they benefit from this measure as it exists.

At the other end of the pay scale, there is no upper cap on income for eligibility. So a married couple who earn €100,000 each, get a €5000 tax break every year by virtue of their dual income status. It is difficult to see how this could be either needed or justified as an incentive for them both to participate in the workforce.

Could it be that higher earners provide more income tax, so it is more of a priority to encourage them to take up paid employment? Or that high earners simply hold more influence on policy? Or both? In any case this is an inappropriate policy in a time of austerity.

6. Conclusion

This is a challenging time for our country economically. It is important to be conscious of not only the financial implications of present policies and proposed reforms, but the social consequences. The “traditional” family of one breadwinner, one parent at home and one or more children is, like many parts of society, under pressure. The contribution made by parents caring for children at home does not register in GDP, unlike paid employment and paid childcare, but is of great value to both parents, children, and society in general. We encourage the government to keep this and the above recommendations in mind when framing financial policies and decisions in the upcoming budget.

APPENDIX 1

Benefit of dual-income standard rate cut off increase for a couple on average wage

	Present policy	**Without increased cut-off**
	€	**€**
Standard rate cut-off	41,800	41,800
Additional cut-off for dual income	**23,800**	**None**
Total standard rate cut-off	65,600	41,800
Salary 1		
Annual gross salary	36,181	36,181
Amount to tax at standard rate	36,181	36,181
Amount to tax at higher rate	0	0
Tax at standard rate	7,236	7,236
Tax at higher rate	0	0
Salary 2		
Annual gross salary	36,181	36,181
Amount to tax at standard rate	*23,800*	*5,619*
Amount to tax at higher rate	12,381	30,562
Tax at standard rate	4,760	1,124
Tax at higher rate	5,076	12,530
Total tax	**17,072**	**20,890**

APPENDIX 2

Present tax mechanism provides no help to couples on two low incomes

	Present policy	**No cut-off increase**	**With tax credit**
	€	**€**	**€**
Standard rate cut-off	41,800	41,800	41,800
Additional cut-off for dual income	23,800	23,800	None
Total standard rate cut-off	65,600	65,600	41,800
Dual income tax credit	None	None	*5,000*
Salary 1			
Annual gross salary	20,000	20,000	20,000
Amount to tax at standard rate	20,000	20,000	20,000
Amount to tax at higher rate	0	0	0
Tax at standard rate	4,000	4,000	4,000
Tax at higher rate	0	0	0
Salary 2			
Annual gross salary	20,000	20,000	20,000
Amount to tax at standard rate	20,000	20,000	20,000
Amount to tax at higher rate	0	0	0
Tax at standard rate	4,000	4,000	4,000
Tax at higher rate	0	0	0
Gross tax	8,000	8,000	8,000
Dual income tax credit	0	0	*5,000*
Net tax*	**8,000**	**8,000**	**3,000**

*Not considering other tax credits for the purpose of simplicity