17 Kildare St.,
Dublin 2.
28th May 2021

Professor Alan Barrett,
Chief Executive Officer,
Economic and Social Research Institute,
Whitaker Square
Sir John Rogerson's Quay,
Dublin 2.

Dear Alan,

While we always welcome the insight provided by ESRI, especially at this point in the budget cycle each year, the Budget Perspectives 2022 Paper 1 published on 21st May "Options for Raising Tax Revenue in Ireland" ("the Paper") has caused considerable disquiet among the small enterprise community, and questions about the objectivity of ESRI have been raised directly with me. Some of the commentary included in the paper, especially that regarding the self-employed, was subjective to the point of editorialising.

Regarding CGT, an inverse relationship between rate and yield has been apparent for some years. While not suggesting that we should revert to the previous rate of 20%, it is likely that a "sweet spot" for this tax lies somewhere around 25%, and yield would improve considerably. We think it would be useful for commentators to state which is more important, rate or yield.

There is an element of confusion in the paper about CAT. CAT was introduced in 1975 as an inheritance/gift tax with a threshold of the equivalent of €190,461. If indexed at the CPI rate, this would now equate to over €1.3m, instead of the current €335,000 ('Group A'). The effect of this is to diminish the attractiveness of intergenerational transfer of business and is one of the reasons so few Irish family businesses reach the scale of their continental cohorts.

For clarity, it is useful to differentiate between the inheritance of property or land by a family member, and the inheritance of a small business (whether hotel, car dealership, hairdresser) or a farm. In terms of asset wealth, the inheritor of a €1m house, land-bank or hotel has increased their gross worth by the value the inheritance. However, in the case of a farm or business inherited as a going concern, their "current assets" have increased only to the extent that the asset generates a net return each year. They can only crystallise their asset wealth by disposing of the asset. That is the reason that up to 90% relief is available, and Ireland's allowances in this regard are not at all out of line with international comparators.[1] The distinction is comparable to the difference between a job offer, and having to actually go to work.

Notwithstanding the observations made in the paper about the management capability of SMEs, particularly family-run SMEs (which, in the Bloom and Van Reenen paper cited by ESRI, extend to

[1] https://assets.kpmg/content/dam/kpmg/xx/pdf/2020/10/global-family-business-tax-monitor.pdf

government-owned firms…), some observations about our enterprise demography are necessary here. Ireland's business demography:

- Is very diverse.
- Comprises 270,344 active enterprises of which SMEs account for 269,803 or 99.8% of the total.
- Employs 67.5% of total persons engaged.
- Accounts for 37.3% of Gross Value Added in an economy with a very significant GVA from FDI.
- Has a strong regional footprint.
- Suffers low productivity only in certain sectors.
- Has a significant challenge in scaling up.
- Has serious concentration risk from FDI dominance and impending global corporation tax change.
- Lacks a coherent government strategy like the German Mittelstand,[2] to scale and improve our indigenous enterprise base.

ISME does not shy away from acknowledging the difficulties and shortcomings of the SME sector. Indeed, we have made clear that they need to be addressed in a structured way, and have been lobbying for several years for a basic business qualification[3] for all business owners (and managers) to tackle them, via the ISME "Blue Cert." And yes, in order to ensure rapid rollout of this educational program, it would have to be incentivised through the PAYE and CAT systems.

Regarding pensions, we would broadly support the observations made in respect of levying PRSI on pension income. Similarly, the tax-free lump sum restriction is a legitimate effort to curtail an EEE situation for a substantial element of an individual's pension pot; although it should be remembered that this entitlement is aligned with that of public sector pensioners who can draw a gratuity which is not a charge on their pension pot. Given the current state of pensions returns, and the impending introduction of auto-enrolment pensions, we believe any further erosion of the ability of private sector workers to save for a decent pension would be both economically undesirable, and run contrary to social policy. A pension pot of €2m sounds very impressive and is enjoyed by relatively few, but on an open-market basis, this pot would be unlikely to provide a pension over €55k per annum. Yet, this size of pension is available to a great many public sector employees who do not consider themselves to be the owners of a large pension pot, and do not make an economic contribution to it. Meanwhile, the average private sector pension pot in Ireland is less than €100k.[4]

ISME can state with great confidence that 100% of private sector workers and the self-employed would happily vacate all the tax "expenditures" (more correctly tax deferments) in pension saving if they could avail of the same defined benefit pension as their public sector colleagues for a maximum gross contribution of 10.5%.

[2] https://www.bmwi.de/Redaktion/EN/Dossier/sme-policy.html
[3] https://isme.ie/blue-cert-proposed-for-irish-sme-sector-2/
[4] https://moneycube.ie/how-far-does-e500k-go-in-retirement

Considering the fact that the defined benefit pension liabilities for the staff of ESRI were assumed by the State under the Financial Measures (Miscellaneous [No. 14.] Provisions) Act 2009, the suggestion of parsimony in the funding of private sector pensions for citizens with pension entitlements far inferior to those of ESRI is problematic.

The self-employed pay precisely the same amount of PRSI as waged persons. The Employer's PRSI contribution is a charge to that business, not a payment, or wages forgone, by the waged employee. The legitimate deductions for a self-employed person are:

- Purchase of goods for re-sale.
- Staff Wages.
- Rent of commercial premises.
- Rates on commercial premises.
- Repairs.
- Lighting and heating of commercial premises.
- Running costs of vehicles or machinery used in the business.
- Accountancy fees.
- Interest paid on business loans.
- Leasing payments on vehicles or machinery used in the business.
- Contributions to a personal pension (up to certain limits).

These deductibles do not exist for employed persons since they are not charges against their earnings. The charge of any other form of expense to the business is straight-forward tax evasion and should be treated as such. In the case of pension contributions for the self-employed, their tax treatment is already less favourable than that of PAYE employees, and far less favourably than that of public servants.

This is not an academic point. The trope that the self-employed can avoid taxation through expense-inflation is currently used as justification for the 3% USC surcharge. The Paper goes on to suggest that this levy could be increased by 1% to raise a "*modest*" €14m per annum. The existing 3% surcharge is totally unjustified. Having campaigned for its removal for years, in the current fiscal environment ISME has decided instead that it should be extended to PAYE workers earning over €100k, and has included this in our Pre-Budget Submission 2022.[5]

Page 19 of the Paper states: "*…there is strong evidence that this relative responsiveness to taxation is driven by the greater opportunities available to the self-employed and company owner-managers to – both legally and illegally – avoid taxes (Saez et al., 2012)*." Note:

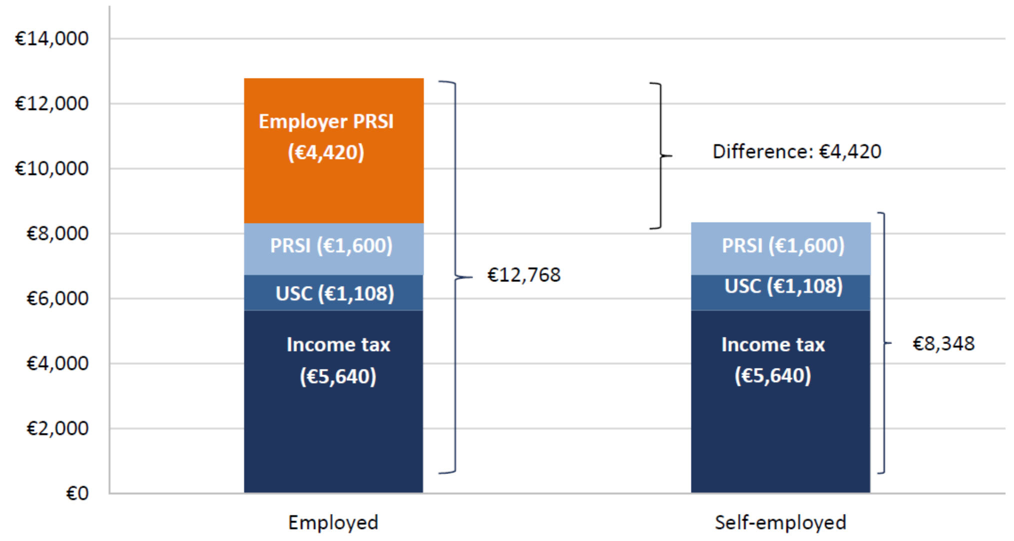
- The legal avoidance of tax is just that: Legal. This is the case for both the waged and the self-employed. The completion of a Form 12 or a Form Med 1 by a waged or self-employed person is de facto tax avoidance; it is also entirely proper. Tax avoidance is not illegal.
- The quotation above is not accurately reflective of the narrative thrust of the Saez et al paper.
- While the self-employed or business owner does have the ability to limit income-drawing from a business in order to inflate its capital value, this is neither tax avoidance, nor is it a

[5] https://isme.ie/pre-budget-2022-submission-to-government/

form of abstinence that would prove attractive to most employed workers (unless they also had an equity stake in the business).

- The authors' confusion on this point is evident in their linking of this section with Capital Gains Tax, which is levied on the difference between the acquisition and disposal cost of an asset. As a once-off transactional tax levied on a disposal, CGT is not comparable to recurring income in any way. Conflating this with regular income is nonsensical.
- The fact this section of the Paper goes on to state that "*a greater level of auditing could itself yield additional revenue*" at least suggests that the authors do grasp the difference between avoidance and evasion, and the real solution to the problem.

Perhaps the best illustration of the failures of the Paper is shown in the figure below, taken from page 31.



Source: Authors' calculations.

This graph at least has the benefit of showing that the employed and self-employed workers pay precisely the same in tax and social contributions. However, it suggests that the employed person is responsible for an extra €4.4k in social contributions, which the self-employed person avoids. NB: both the workers above have a net income of €31,652.

To illustrate the folly of this proposition, consider two self-employed taxi-drivers, Joe and Joanne, who drive the same make of taxi and turnover €90k per annum. Both deduct €40k per annum in fixed and variable operating expenses, leaving a gross margin of €50k. Joe takes this €50k as income, and pays tax and social contributions at the current rates, leaving him with a net income of €35.1k.

Joanne, however, pays employer's PRSI on her gross margin, of €5.5k. This means that her income for Revenue purposes is NOT €50k. It is €44.5k. (The Personal Credit has not been applied to either.)

	JOE	JOANNE
Gross Income	50,000	44,475
USC	1,553	1,304
PRSI	2,000	1,779
PAYE	12,940	10,730
Tax Credit	- 1,650	- 1,650
Total Deductions	14,843	12,163
Net Income:	35,157	32,312
Employer's PRSI:	0	5,525
Employee Social:	3,553	3,083
Employee Tax	11,290	9,080
Total Exchequer Contribution:	14,843	17,688

While the total contribution to the Exchequer in Joanne's case is €2.8k greater, this contribution comes at the cost of €2.8k to Joanne's net income. The Revenue can only remove a euro once from the business. Joe's net income reflects Revenue rules whether Joe is an employed or self-employed driver. The ESRI suggestion would charge the employer's contribution to the employee- something neither ESRI, nor in its public pronouncements ICTU, seem to appreciate.

Likewise, p32 contains the following: "*While many self-employed are involved in 'entrepreneurial activities' such as employing others, innovating and investing, those operating as self-employed include everyone from taxi-drivers to IT consultants and barristers. Blanket lower rates of tax – including PRSI – are therefore poorly directed at encouraging entrepreneurship or business start-ups.*" If Joe the taxi-driver in the example above was employed by a taxi-firm, his personal contribution to the exchequer would remain the same, but the taxi-firm would charge to its operations 11.05% in respect of its PRSI obligations. Joe's contributions to the state remain the same whether he is self-employed or an employee. It does not follow that self-employed consultants or barristers should form themselves into limited companies in order to operate, and pay PRSI not payable by employees.

The paper does not specify what the other "*blanket lower rates of tax*" are, and as pointed out above, the assertion on employer's PRSI is based on the erroneous notion that income for an employee is comparable to turnover for a self-employed person.

Therefore, the assumption shown on p44 that if we "*Equalise self-employed PRSI treatment to employees*" we will generate an extra €1.15bn in Exchequer revenue is entirely bogus. While the footnote attached to this calculation states the author has taken account of the reduction in PAYE and PRSI (from the self-employed person), we are not sure that this is the case. In the case of Joe versus Joanne above, while the Exchequer wedge has increased by €2,845, this has come at the expense of a fall of €2,845 in Joanne's "employee" contributions, and a fall of €2,845 in Joanne's net income. This is quite a profound misunderstanding of a simple concept by ESRI.

Compared to our EU neighbours, it is our employee contributions to the social fund (at 4%) which are extremely low. Employee/Employer contributions in Germany[6] are double ours, or more, and are

[6] https://taxsummaries.pwc.com/germany/individual/other-taxes

equally divided between employer and employee. As unpalatable as it may be, our personal social insurance contributions will have to increase, across all income ranges including lower ones.

While we do not expect ESRI to perform a detailed examination of State expenditure, the fact that Ireland's current spend has ballooned so quickly in the last year, and not just on pandemic-related expenditure, should attract some commentary. Yes, we need to extract more tax, but not every expenditure is justified. IFAC's latest fiscal report (p.42)[7] shows non-Covid increases in core government expenditure of over 3.3% in 2022 and 2023. The OECD has identified[8] systemic under-performance in our health, education and law enforcement performance, yet the only policy prescription appears to be "more money." This month's commentary from the Irish Fiscal Advisory Council[9] was notably explicit on the matter; further revenue-raising measures through increased taxation are not an alternative to managing a credible medium-term expenditure framework.

Lastly, I must regrettably make the (unscientific) observation that the authors of this report do not appear to "like" entrepreneurs or businesspeople in general, or the self-employed in particular. The self-employed are characterised in this report as people who choose their employment status with a view to minimising their contributions to the Exchequer, as if there is "something of the night" about them. There is no recognition of the harsh reality of life for most of them in terms of risk, profitability, earnings, job security, holidays, pension etc. There is but a passing reference to their provision of employment. This stands in marked contrast to public sector workers who have job security, guaranteed incomes regardless of merit or effort, guaranteed pensions and no exposure to the realities of the market economy.

Yours sincerely,

Neil McDonnell
Chief Executive

CC Minister for Finance, Paschal Donohoe TD
Minister for Public Expenditure and Reform, Michael McGrath TD
Tánaiste and Minister for Enterprise, Trade and Employment, Leo Varadkar TD
Minister of State Robert Troy TD
Minister of State Damien English TD
Mr Derek Moran, Secretary General, Department of Finance
Mr David Moloney, Acting Secretary General, Department of Public Expenditure and Reform
Mr John Hogan, Assistant Secretary General, Department of Finance
Dr Orlaigh Quinn, Secretary General DETE
Mr Declan Hughes, Assistant Secretary General DETE

[7] Fiscal Assessment Report May 2021
[8] OECD Economic Survey Ireland 2020
[9] https://www.fiscalcouncil.ie/fiscal-assessment-report-may-2021/