TSG No: 09/10

Department of Social and Family Affairs

PRSI issues for 2010

29 Sept. 2009

1 Social Insurance Fund Finances

Social insurance spending has traditionally been funded on a tripartite basis – with contributions coming from the Exchequer, employers and employees. Legally, the Exchequer is the residual financier of the Fund and Exchequer contributions were the norm for over forty years – for example, in 1967, the State contribution was 38% of SIF expenditure; and almost 29% in 1985. However, no Exchequer contribution has been required since 1996 as the Fund has been in surplus on foot of contributions from employers and workers.

The Actuarial Review of the Social Insurance Fund, 2005 advised that significant increases in contribution income will be required in future years – if the policy imperative is to be maintenance of current distributions from the SIF. In line with current pensions policy DSFA supports the view that that progressive action is required if future public pension liabilities (and other SIF liabilities) are to be met. This will involve finding an appropriate balance between the three strands of the tripartite funding system but also building a closer relationship between benefit rates/conditions and contribution rates, and gauging the cost of credits.

Financing of the Social Insurance Fund, 2008

• Employer PRSI – 73%	• Employee PRSI – 20.1%
• Self-employed PRSI – 5%	• Investment income and other receipts – 2%.

Financial position of the Social Insurance Fund – 2007, 2008, 2009

Income Source	2007 €000	2008 Provisional €000	2009 Actual to end July* €000	2009 Profile to end July* €000
Employer/Employee Contributions	7,301,158	7,577,731	4,310,100	4,346,870 (End year 7,103,000)
Self-Employed Contributions	420,852	405,581	97,800	110,980 (End year 379,000)
Other Income	112,137	160,228	67,406	41,429
Total Income	7,834,147	8,143,540	4,457,784	4,499,279
SIF Scheme Expenditure	7,008,279	8,388,258	5,478,688	5,537,374
Admin Expenditure	242,711	257,845	157,421	157,067
Surplus	583,157	**(224,718)**	**N/A**	**N/A**
Accumulated Surplus	3,632,298	3,401,413	N/A	N/A

* Figures in this table are drawn from different sources – for indicative purposes only.

Trend in SIF income vs. expenditure
As the above table demonstrates the SIF recorded an annual (provisional) deficit of €225m in 2008. The most recently available returns demonstrate that employer/employee PRSI is holding up well at just below profile. It is possible that these returns may, by year end, exceed profile and return to 2007 levels.

However, the table also shows that self-employed returns are down sharply. This has implications, which will require careful examination in light of emerging Macros, for the value of policy measures such as the Tax Commission recommendation to raise the S/E rate from 3% to 4%.

The accumulated SIF surplus at year end is now estimated to be just over €1bn. While this represents an improvement on REV estimates (€0.65bn) exhaustion of the surplus is still expected in 2010, requiring an Exchequer subvention to the SIF of some €2.7bn (This estimate is expected to be revised downwards in light of most recent macros).

2 PRSI changes advanced by DSFA

The following issues have been advanced previously by DSFA. They are largely consistent with the recommendations of the McCarthy group and the Commission on Taxation.

2.1. PRSI Band issues

PRSI Class A encompasses up to 80% of all social insurance contributors – it being the standard Class for full-time employees. It features a PRSI-Free Allowance as well as 4 main sub-classes that articulate different policy objectives in relation to charges imposed on both employees and their employers. There is significant scope within the operation of the PRSI system for reforms which would have targeted impacts on the costs of employing – particularly with regard to low-paid workers.

The following is an example of how Class A might look in 2010. This example is broadly cost neutral – with the lower rate of employer PRSI increased from 8.5% to 9.5% but this lower rate extended further up the income scale.

Example of PRSI Class A – 2010:

Subclass	Weekly Pay Band	How much of weekly pay	First €75,036		Over €75,036	
			EE	ER	EE	ER
AO	€38 - €370 inclusive	ALL	Nil	9.50%	Nil	9.50%
AX	€370.01 - €500 inclusive	First €127	Nil	9.50%	Nil	9.50%
		Balance	4.00%	9.50%	Nil	9.50%
A1	Over 500	First €127	4.00%	10.75%	4.00%	10.75%
		€127.01 - €1,443	8.00%	10.75%	4.00%	10.75%
		Balance	9.00%	10.75%	5.50%	10.75%

*** Current PRSI Class A is included at appendix A, Page 10**

Such a rationalisation of the A Class has the potential to reduce the cost of employment for workers below €500 p.w.

It may be possible to achieve such a rationalisation at a minimal/zero cost approach or the cost could be offset through a 1% increase in self-employed PRSI and/or the removal of the employee PRSI ceiling – various structure and rate combinations will be examined over the coming weeks.

2.2. Introduction of a minimum earnings threshold for full-rate PRSI

Class **J0** covers all persons – including medical card holders and certain social welfare recipients – who are employed under a contract of service with reckonable earnings of less than €38 per week. Persons paying Class J rates are covered in respect of Occupational Injuries Benefit. Class **A0** applies to all employees – including medical card holders and certain social welfare recipients who are normally employed under Class A but whose reckonable earnings are between €38 and €352 per week. Neither Class pays an employee or health levy contribution. As it currently stands, an employee working some 4.5 hours or less per week at the minimum wage is gaining a PRSI credit and, subsequently, entitlement to social insurance benefits.

As currently constituted, the PRSI Classes allow persons with a minimal attachment to the workforce to obtain the same benefits as full-time employees. This anomaly contradicts the contributory principle of the social insurance system.

If the original contribution level of €38 equivalent had been raised in line with prices since it was first introduced, it would now stand at €55 and represent a more meaningful level of engagement with the labour market before benefit entitlements are receivable. If the €38 equivalent had been raised in line with industrial earnings, it would now stand at circa €70.

It may be noted that when the method of determining 'employment of inconsiderable extent' was changed in 1991, £26/€33 replaced 18 worked hours as the base line.

2.3. Introduction of a minimum income threshold for self-employed contributors

Self-employed persons with a total income of €3,174 or more in the 2009 tax year pay social insurance contributions at the PRSI Class S rate. These contributions are paid on a person's gross income – less capital allowances and allowable superannuation.

- Those who pay their tax directly to the Collector-General will pay their social insurance contribution and their health levy contribution with their income tax. They will have to pay a social insurance contribution of 3% of all income, or €253, whichever is greater, as well as the health contribution, where applicable.
- Those paying PAYE tax will have their contributions deducted from their income by their employers.
- Those who have been told by an Inspector of Taxes that they need not make a return of income must pay a flat rate contribution of €157 to this Department. These contributions can be paid in instalments.
- Those whose main income comes from share-fishing and who have been classified as self-employed workers may opt to pay an extra contribution for certain benefits under PRSI Class P. In addition to the Class S contribution, they will pay a contribution of 4% on income over the PRSI-Free Allowance of €2,500 *per annum*, up to a ceiling of €50,700, or pay €200 – whichever is greater.

These arrangements allow self-employed contributors with reckonable income of €3,174 *per annum* (i.e. €61 per week) access to social insurance coverage – again, representing bad value-for-money and a detriment to the equity and integrity of the social insurance system.

This amount has not changed since it was first introduced in 1998. It was set, at the time, by reference to the rate of the Old Age (Non-Contributory) Pension. While it is not proposed that the PRSI threshold for self-employed persons match the current rate of the State Pension (Non-Contributory) it should be raised to a level that adequately reflects the benefits that can accrue from social insurance coverage. Any move to a more realistic level of contribution in this regard would probably be best done on a phased basis over a period of years – and similar consideration to appropriate phasing could be given in respect of the employee threshold above.

2.4. Flat rate self-employed contributions and Voluntary Contribution rates.

Self-employed workers aged between 16 and 66 years and with reckonable income that exceeds the current insurable limit of €3,174 *per annum* pay PRSI contributions at Class S. The contributions are due at 3% of reckonable income, or €253, whichever is the greater.

The flat rate of €253 (£200) has been in existence since 2001. If the current insurable limit of €3,174 were to be increased, it would be logical that this flat rate should also rise accordingly. Paying €253 for a full year of contributions represents excellent value for money in terms of accrued pension entitlement – in light of current initiatives regarding the sustainability of the pensions system, allowing such a minimal contribution would appear to be unsustainable.

€253 is also the rate at which formerly self-employed persons pay Voluntary Contributions in order to protect their pension entitlements. If the Class S flat rate were increased, this rate would normally follow suit.

2.5. Broadening the Base

PRSI is generally levied on income arising from insurable employment or self-employment. As a result the PRSI base is narrow compared to that for general taxation.

Consistent with the Commission on Taxation recommendations, consideration should be given to broadening the PRSI base to include unearned income, such as rental income, and share based remuneration. However, the issue of how or whether a PRSI credit may be awarded in respect of this PRSI may present difficulties.

These will be discussed with Dept. Finance and Revenue with a view towards making progress on this agenda in the 2010 Budget.

3 McCarthy / Tax Commission recommendations

The recommendations of the Tax Commission and the McCarthy group in relation to PRSI are set out in appendix A. DSFA is generally supportive of the recommendations. In particular, the Department welcomes the TC recommendations 5.19 - that the Health Contribution be integrated into the income tax system, and 5.20 – that the National Training Fund Levy be abolished. However, it is noted that while the recommendations are sensibly proposed for the longer term in light of the current fiscal situation, the abolition of these levies has been proposed before but not implemented.

3.1 McCarthy Report

Further work should be done on examining:
- *changes in the rates and structures;*
- *elimination of exemptions;*
- *base widening; and*
- *simplification of the current complex rating structure.*

This work should be completed in time for consideration in Budget 2010.

3.2 Tax Commission

Short & medium term recommendations

5.9 In view of the burden on the Exchequer, the PRSI base should be broadened.

Supported by DSFA. This recommendation is made in light of current shortfall in Social Insurance Fund (SIF) income vis-à-vis expenditure, and expected future shortfalls as highlighted in the Actuarial Review of the SIF and the Pensions Green Paper process.

5.11 A similar PRSI base should apply to employees and the self-employed and there should be a single rate of charge which should apply to both.

The rate of contribution paid by self-employed persons (3%) has not changed since 1989. Alignment with the employee rate of 4% is logical. **Supported by DSFA** – There may be some problems with alignment of the bases of income for employees and the self-employed but the Department is generally supportive of the proposal.

5.12 The employer PRSI ceiling should not be reintroduced.

Supported by DSFA – As the Commission state 'The rates at which social insurance contributions are paid are low by international comparison and the cost of reinstating a ceiling would exacerbate the projected deficits of the SIF in meeting its liabilities'.

5.13 The employee ceiling should be abolished and this should be done on a phased basis.

The employee ceiling, above which employees pay no further PRSI, reduces the equity of the system as higher paid employees pay proportionately less of their income than low paid employees. **Supported by DSFA –** Given that the ceiling was substantially raised from €52,000 to €75,036 in the 2009 Supplementary Budget, the view could be taken that implementation of this recommendation is already in train.

5.14 Employees should be subject to PRSI on unearned income such as investment and rental income.
5.15 Share based remuneration, including share options, should be subject to PRSI.

Supported by DSFA - These recommendations seek to broaden the PRSI base and are generally welcomed. There may be some technical issues with implementation but the feasibility of progression in the short-term will be examined.

5.16 Relief from PRSI should apply in respect of pension contributions made by self-employed contributors subject to a minimum PRSI contribution to secure future entitlement to benefits.
5.17 Trading losses should be deductible for PRSI purposes subject to the payment of a minimum annual PRSI contribution.

Supported by DSFA - These recommendations seek to remove anomalies from the self-employed PRSI system and bring it more into line with the tax system. The Department would suggest that implementation would need to involve careful examination of what should constitute a 'minimum contribution'.

Long-term recommendations

5.10 – There should separate comprehensive consideration of the PRSI system.

The Commission term-of-reference do not extend to the totality of the PRSI system, so they have only looked at the contribution side of the system. However, they note that the system lacks simplicity, equity and efficiency and recommend a comprehensive review. **Supported by DSFA** – Such an exercise could be very beneficial. Scoping for the next Actuarial Review is due to start next year. This affords the opportunity to have this and other allied proposals costed and assessed for impact. The Dept. Finance will be involved in this process and any subsequent discussion on timelines.

5.18 The step effect in PRSI and the Health Contribution should be eliminated.

The level of the weekly social insurance contribution that is payable is, for the most part, determined by both the level of reckonable earnings in that week and the appropriate PRSI rate. The PRSI exemption on low earnings is €352 per week – any earnings above this level are liable to an employee PRSI contribution rate of 4%. Above this threshold point contributors are entitled to a PRSI-Free Allowance of €127 per week that reduces the 'step-effect', whereby an employee with gross weekly pay over €352 could have lower net pay that an employee earning €352 or less per week, of the threshold. Therefore, a person insured with an income up to €352 per week will have a nil liability whereas a person with an income of more than €352 per week will have a PRSI liability of 4% on the portion of that income above the €127 PRSI-Free

Allowance.

Supported by DSFA – Though strongly supported, the proposal will require detailed consultation with Revenue, Dept. Finance and other stakeholders with regard to operational feasibility.

5.19 The health contribution levy should be integrated into the income tax system.
5.20 The National Training Fund levy should be abolished and a different approach to funding the National Training Fund should be put in place.

The two levies do not support SIF income and, particularly in the case of the Health Contribution, significantly increase the complexity of the system. These levies are taxes and should not be part of the PRSI system.

Supported by DSFA - As stated above these recommendations are particularly welcome. However, previous experience would suggest that finding the right time for their re-integration into the tax system will be difficult. Therefore implementation will require significant political and administrative support

Appendix A: PRSI Class A – from May 2009

Class A - 1st May 2009

Subclass	Weekly Pay Band	How much of weekly pay	First €75,036		Over €75,036	
			EE	ER	EE	ER
AO	€38 - €352 inclusive	ALL	Nil	8.50%	Nil	8.50%
AX	€352.01 - €356 inclusive	First €127	Nil	8.50%	Nil	8.50%
		Balance	4.00%	8.50%	Nil	8.50%
AL	€356.01 - €500 inclusive	First €127	Nil	10.75%	Nil	10.75%
		Balance	4.00%	10.75%	Nil	10.75%
A1	More than €500	First €127	4.00%	10.75%	4.00%	10.75%
		€127.01 - €1443	8.00%	10.75%	4.00%	10.75%
		Balance	9.00%	10.75%	5.00%	10.75%

Appendix B: Commission on Taxation & McCarthy Reports PRSI Sections

Commission on Taxation

The interface between the tax and social welfare systems
3.1 The pay related social insurance (PRSI) system

3.1.1 Introduction

Our terms of reference asked us *"to consider the structure of the taxation system"* and to examine and review a number of specific questions. In this connection, the interface with the social welfare system is an important structural issue which needs to be considered.

We carried out our examination of this area under the following headings.

- The PRSI system
- Integration of the tax and social welfare systems
- Refundable tax credits
- The tax treatment of social welfare payments

The treatment of cohabiting couples under the tax and social welfare systems is addressed separately in section 2.3 which deals with the unit of taxation.

3.1.2 Description of the PRSI system

The social insurance system in Ireland comprises two key features, namely a social solidarity component and a contributory principle. The social solidarity component means that the costs of social benefits and programmes are shared collectively by society. The contributory principle means that individuals build up entitlement to benefits for both themselves and their families if and when a particular contingency arises. The social insurance system provides cover for a large range of social welfare payments to workers and their dependants.

PRSI contributions, which are collected mainly through the income tax system, provide the main source of funding for the system. There are 11 different classes of PRSI, and over 30 subclasses within these, and the class applicable determines eligibility for various benefits.

PRSI is made up of a number of different components:

- Social insurance, payable by employees, employers and the self-employed, is administered by the Department of Social and Family Affairs which provides a range of social welfare benefits and pensions
- The health contribution levy, payable by employees, goes to the Department of Health and Children to help fund health services
- The national training fund levy, payable by employers of Class A and H contributors, goes to the Department of Enterprise, Trade and Employment to support a broad range of employment training initiatives

3.1.3 Social insurance fund

Social insurance contributions by employees, employers and the self-employed form the Social Insurance Fund which is used to fund social insurance payments, including social welfare pensions.

An actuarial review of the social insurance fund was carried out for the Minister for Social and Family Affairs in 2005. The main conclusion of the review was that, while total income to the Social Insurance Fund is projected to equal or exceed benefit outgoings in the period to 2010, thereafter the net cash flow position is projected to decline rapidly.

Ireland has yet to face increased future pensions liabilities as a consequence of population ageing. The fund's finances are critically affected by the structure of the population and the labour force. The population projection carried out for the purposes of the Actuarial Review in 2005 indicates that the number of people of working age for each person aged 65 years or over is projected to fall from a ratio of almost 6:1 in 2006 to almost 2:1 in 2061. As a consequence of this, the Social Insurance Fund will require ongoing Exchequer subvention to meet increased pension liabilities. This could mean that consideration will have to be given in the medium term to the adequacy of Ireland's PRSI levels and whether they should be increased towards levels pertaining elsewhere across Europe. Increases in rates of PRSI, in particular employer PRSI, would likely have a negative impact on employment. The difficulties in this area suggest that the base for PRSI should be broadened where possible.

Recommendation 5.9
In view of the burden on the Exchequer, the PRSI base should be broadened.

3.1.4 PRSI – social insurance or a tax?

The question of whether PRSI is a social insurance or a tax has been considered on a number of occasions. The previous Commission on Taxation concluded that social insurance is a form of taxation and that social insurance contributions should be replaced with a social security tax assessed and collected on the same basis as income tax. The Commission on Social Welfare (1986) took issue with the categorisation of social insurance as a tax and regarded the system of social insurance contributions as having a significant insurance dimension, which is not outweighed by the absence of an actuarial link between benefits and contributions.

We consider that, on one hand, PRSI can be regarded as an insurance arrangement. The purpose of any social insurance system is to fund a range of social welfare benefits to workers and their dependants. A social assistance system is also operated to assist people without adequate insurance entitlement. By making PRSI contributions, workers obtain entitlements to benefits. While it is a fact that the benefits will not vary by reference to the quantum of contributions made, the system is designed as an insurance-type scheme that provides benefits to those who make contributions.

On the other hand, the fact that there is no direct correlation between contributions made and entitlement to benefits under the system suggests that it does not have all the hallmarks of an insurance scheme. Those who pay higher contributions do not have an entitlement to correspondingly higher benefits. While it may be appropriate that those on higher incomes should make higher contributions in the context of fairness, it could be argued this may be more a feature of a tax system than an insurance arrangement. Our general conclusion was that PRSI has some characteristics of a tax and therefore that the contribution side should be examined by us.

We therefore examined PRSI to the extent that it has an impact on our terms of reference. We note the complexity of the PRSI system and its wide scope covering both benefits and contributions. Our consideration of PRSI is not intended to be comprehensive and such a consideration is, in any event, outside our terms of reference. We confined our examination to the contributions side of PRSI and to examining anomalies within various categories of contributors. This is the aspect of PRSI that is in the nature of a tax. It became very clear, however, during our examination that the overall PRSI system is complex, unwieldy and contains significant anomalies. We consider that there should be a separate comprehensive consideration of the PRSI system.

3.1.5 PRSI measured against our principles

Because PRSI interacts with the tax system and impacts on the tax wedge it is a part of the costs of employment. Employee PRSI is similar to income tax as regards the tax wedge.

We measured PRSI against our principles of simplicity and equity and also against efficiency. We concluded that PRSI is regressive by its nature, fails the simplicity and efficiency tests and challenges the equity principle. Other considerations may be relevant to measure its appropriateness as a social insurance. This, however, is not a matter for us.

Simplicity

PRSI fails on simplicity. There is no doubt that the system is complex. There are 11 classes of contributions and insurability and over 30 subclasses within these.

The complexity of the system imposes a considerable burden on employers and also on contributors due to different contribution rates payable that are dependent on the nature of employment income. There is also complexity for contributors as similar income is subject to different rates depending on whether the contributor is an employee or is self-employed.

Equity

PRSI may conflict with the equity principle. The application of a ceiling on employee contributions means that PRSI is regressive in that those earning more than the ceiling pay a lower proportion of their income in PRSI than those earning less than the ceiling. This conflicts with vertical equity. PRSI does not apply to all income and this conflicts with horizontal equity. It is difficult to come to an overall conclusion on whether the system is fair without taking account of the rules as regards both contributions and benefits. Deficiencies in equity on the contributions side might be explained by the fact that the system is a social insurance system and that, in attempting to determine whether it is equitable on an overall basis, account needs to be taken of benefits as well as contributions.

Efficiency

A tax system should facilitate the optimal use of resources. It should not have measures that are likely to discourage the efficient use of resources. PRSI, while a social insurance system intended to provide benefits to individuals in return for contributions, imposes a cost on labour. Depending on the state of the labour market, employees will tend to focus on take home pay and, to the extent that they do so, employee PRSI may be a cost of employment falling on employers. Similarly, employer PRSI may not impact directly on the take home pay of employees. Thus, PRSI (both employee and employer contributions) may be a labour cost borne by employers and may act as a disincentive to employment. To that extent, PRSI can be seen as failing the efficiency test.

3.1.6 The PRSI structure

In the two most common PRSI contribution classes (A1 and S1)[1], PRSI applies at a rate of 4% on reckonable earnings of employees, 3% on reckonable income of the self-employed and there is a charge on employers at a rate of 10.75% of their employees' reckonable earnings. The base for the self-employed is wider than that for employees but the rates applying are different. We consider that a similar base should apply to employees and the self-employed and a single rate of charge should apply.

Employer PRSI should be regarded as a payment to cover employment-related benefits, such as jobseeker's benefit, illness benefit, occupational injuries benefit and health and safety benefit which are available only to employees[2], while other benefits[3], which are available to all workers, should be linked to the employee and self-employed PRSI.

Recommendation 5.11

A similar PRSI base should apply to employees and the self-employed and there should be a single rate of charge which should apply to both.

3.1.7 PRSI as part of the tax wedge

The impact of PRSI as a part of the tax wedge is similar to the impact of income tax on employment costs and therefore is relevant to competitiveness. The tax wedge is defined by the OECD as "the gap between the labour costs the employer pays and the corresponding net take home pay the employee receives". It includes income taxes and social security contributions. A high tax wedge increases the costs of employment. A low tax wedge indicates a reduced cost of employment and incentivises employers to take on employees. The level and structure of taxes are major influences on the functioning of labour markets. With workers and companies becoming increasingly mobile, it is important that the tax burden on labour is minimised.

3.1.8 Employer PRSI contribution

[1] For convenience, we refer to persons in these two classes as employees and self-employed respectively. We recognise that the S1 class applies to some employments.

[2] Employed contributors also have entitlement to treatment benefit, carers benefit, invalidity pension and State pension (transition).

[3] Both self-employed contributors and employed contributors have entitlement to the following benefits: State pension (contributory), widow or widower's pension
(contributory), guardian's payment (contributory), maternity benefit, adoptive benefit and bereavement grant.

It has been argued that the rate of the employer PRSI contribution, generally 10.75%, can be seen as a disincentive to employment given that it applies without a ceiling[4] and that the removal of the ceiling had a disproportionate impact on industries and business that one would wish to attract to Ireland. It has also been claimed in submissions that a reduction in employer PRSI would incentivise employers to retain and increase staff numbers, thus having a multiplier effect on the economy and increasing Ireland's competitiveness. To reinstate the ceiling would reduce employment costs and aid competitiveness and could stimulate employment.

However, it would not be appropriate to reinstate the employer PRSI ceiling given international comparisons. The rates at which social insurance contributions are paid are low by international comparison (although it is acknowledged that the corresponding benefits vary considerably) and the cost of reinstating a ceiling would exacerbate the projected deficit of the Social Insurance Fund in meeting its liabilities.

Recommendation 5.12
The employer PRSI ceiling should not be reinstated.

3.1.9 Employee PRSI contribution

An annual contribution ceiling of €75,036 applies in the case of employees and there is no ceiling in respect of the self-employed. Once an individual's earnings exceed this cut-off point, no further employee PRSI is payable. It seems inequitable that individuals on high income do not pay PRSI on all their income. However, additional contributions paid do not result in higher benefits. Abolishing the ceiling would increase the tax wedge and could have implications for employment costs. It could also affect Ireland's competitive position. Abolishing the ceiling would address the equity issue and could give an additional yield to the Social Insurance Fund. It would also improve social solidarity where costs of social benefits are shared collectively by society.

On balance, we believe that the employee PRSI ceiling should be abolished. However, in order to mitigate the impact on the employees concerned and on employment costs, and noting the current marginal rates since introduction of the income levy, we consider that the abolition should be on a phased basis.

The estimated additional yield to the Exchequer would be about €150 million in a full year.

Recommendation 5.13
The employee PRSI ceiling should be abolished and this should be done on a phased basis.

3.1.10 Incorporating PRSI into general taxation

We considered incorporating employee PRSI into the general taxation system. In effect, this would separate benefits and contributions. The cost of benefits would simply be an item of Exchequer expenditure to be met out of general taxation. The overall taxation burden would remain unchanged, but the amount of tax collected under the income tax heading would rise and that collected via employee PRSI would cease. There would be a substantial increase in the headline rates of income tax with

[4] There was an employer PRSI ceiling up until 2001.

possible negative perceptions. For example, abolition would require an increase of about three percentage points in the standard rate or a seven percentage point increase in the higher rate of income tax. In the absence of counterbalancing measures, the increase in the standard rate would mean that lower earners would be brought into the tax net. The link between financing the social support system and its costs and benefits would be less apparent. Replacing social insurance with a tax could also have implications for existing and accruing entitlements. We do not recommend this course.

3.1.11 Comparison of the bases

We considered the possibility of having a common base for income tax, PRSI and, if they are retained, the health contribution levy and the national training fund levy. The base on which PRSI is charged differs substantially from the base for income tax purposes. A comparison of the bases, including the bases on which the health contribution levy, income levy and the national training levy are applied, is set out in Annex 8. Liability to PRSI is calculated on an individual basis and takes no account of marital status or dependants, as is the case with income tax. This is because it is an insurance payment from which an individual may derive benefits. Unlike income tax, there is no liability to PRSI when an individual reaches 66 years of age[5]. Apart from the employee PRSI ceiling, the other significant differences relate to income tax exemption limits for individuals over 65 years and deductions and allowances which are an intrinsic feature of the income tax system and the more extensive tax expenditures in the income tax system.

Moving to a common base would considerably simplify the system. However, there are several difficulties that would have to be addressed in any move to a common base:

• Different methods of categorising income
• Inconsistency in allowable deductions
• Different exemption limits, thresholds and ceilings applicable
• Different age-related exemptions under PRSI and income tax
• Exemptions for particular classes of individuals in the case of employee PRSI
• The fact that income tax takes account of marital status and dependants, and
• The complexity of the PRSI system and different benefit entitlements

Approaches to getting a common base might be either to apply the income tax base for PRSI purposes or to apply the PRSI base for income tax purposes, or perhaps a hybrid of some sort. The difficulty in trying to fully conform the base is that PRSI and income tax have very different roles.

PRSI is designed to build up entitlement to benefits while income tax is designed to charge a tax on the income of a person to finance government expenditure.

While having a common base is desirable for simplicity reasons, achieving it fully may not be feasible.

[5] PRSI Class K applies to individuals in receipt of an occupational pension, certain office holders (for example, judges and State solicitors), and individuals over 66 years of age, previously on Class S. A PRSI contribution is not payable and there are no benefits accruing. Only the health contribution levy is payable. Class M is for individuals with no contribution liability such as employees under 16 years of age or individuals within Class K with a nil health contribution levy liability (for example, medical card holders). Class J normally applies to people with reckonable pay of less than €38 per week. However, it also applies to some individuals aged over 66 years or over or people in subsidiary employment. Only the health contribution levy is payable by the employee. An employer PRSI contribution of 0.5% is payable.

3.1.12 Anomalies within the PRSI system

Investment income

Self-employed contributors pay PRSI on income, including income such as investment and rental income. In the case of employees, investment income and rental income are not subject to PRSI unless the individual is also chargeable to PRSI as a self-employed person. We recommend that employees should be subject to PRSI on unearned income. This would broaden the base and improve equity. From an operational point of view, consideration could be given to withholding contributions at source in the case of income on deposits and other savings products.

It is not possible to provide an accurate estimate of the potential yield.

Recommendation 5.14
Employees should be subject to PRSI on unearned income such as investment income and rental income.

Share-based remuneration

PRSI is not charged on share option gains or remuneration in the form of shares because these do not constitute ‘reckonable earnings’, ‘reckonable emoluments’ or ‘reckonable income’ for the purposes of the Social Welfare Consolidation Acts. In the case of share options this is contrary to the treatment in most OECD countries where social insurance contributions are payable on share option gains. Share-based remuneration is a form of income and charging PRSI would remove the bias in the PRSI system in favour of share-based remuneration rather than cash remuneration. The PRSI treatment of share-based remuneration should mirror the PRSI treatment of other employment income. We acknowledge that there are likely to be significant administrative issues associated with the implementation of this recommendation.

It is estimated that the additional yield from this measure is about €29 million.

Recommendation 5.15
Share-based remuneration, including share options, should be subject to PRSI.

Pension contributions by self-employed contributors

Employees can claim exemption from PRSI for contributions in respect of occupational pension contributions. Self-employed contributors who are subject to the PAYE system (proprietary directors) may avail of PRSI relief on payments to occupational pension schemes. In the case of self employed contributors outside the PAYE system, there is no exemption from PRSI where contributions are made towards pension provision. This is not consistent with the principle of horizontal equity. The Department of Social and Family Affairs does not consider that a question of inequity arises when the wider issue of the treatment of the self-employed is considered in the general context of social insurance coverage. We consider that, to achieve equity between contributors, relief from PRSI should apply in respect of pension contributions made by self-employed contributors, subject to paying a minimum PRSI contribution to secure future entitlement to benefits. However, in Part 10, we recommend a matching Exchequer contribution as the best way to give tax relief for pension contributions. If the latter recommendation is adopted, PRSI relief will not arise and the question raised here is not relevant. This recommendation therefore will not be necessary.

It is estimated that the additional cost of this will be about €34 million in a full year.

Recommendation 5.16
Relief from PRSI should apply in respect of pension contributions made by self-employed contributors, subject to payment of a minimum PRSI contribution to secure future entitlement to benefits.

Losses
Losses incurred in a trade or profession are not deductible for PRSI purposes. It is difficult to see the rationale for the exclusion of a deduction for actual losses incurred in a trade from income for PRSI purposes except for a situation whereby offsetting losses could reduce income subject to PRSI to zero, so that the individual would not be building an entitlement to future benefits. We recommend that trading losses be deductible for PRSI purposes subject to the payment of a minimum annual PRSI contribution.

We estimate the additional cost of this will be about €9 million in a full year.

Recommendation 5.17
Trading losses should be deductible for PRSI purposes subject to the payment of a minimum annual PRSI contribution.

Step effect
Inconsistencies arise because of the manner of application of exemption limits in PRSI. Unlike income tax which applies on a graduated basis, liability to PRSI (and health contribution levy) applies on all income where the exemption limit is exceeded, thereby creating a 'step effect'. An employee is exempt from PRSI where annual earnings are less than€18,304. However a liability of €468 in respect of employee PRSI arises where income increases from €18,304 to €18,305. Similarly, PRSI is not payable by a self-employed contributor where the income is less than €3,174. However, where income exceeds this limit, PRSI is payable on all income at the rate of 3% or €253 whichever is greater. Accordingly, an individual with self employment income of €3,175 will have a PRSI liability of €253.

We considered a number of options to resolve this issue. A common base or the adoption of a graduated system where income is marginally in excess of the exemption limits would go some way to address these inequities. However, this would involve significant Exchequer costs and could impact adversely on low income earners. We recommend the elimination of the PRSI step effect which impacts on employees through the removal of the weekly PRSI exemption limit (€352) and the weekly PRSI free allowance (€127) and their replacement with a reducing non-refundable equivalent PRSI credit of €14.08 per week (€352 x 4%). The credit would be due in full where earnings do not exceed €352 per week, ensuring that all earners with a liability below €352 per week will continue to have no liability to PRSI. For earnings above €352 per week, the amount of the credit could be gradually reduced. This would eliminate the step effect from the system while maintaining the benefits of the existing exemption and PRSI free weekly allowances.

Table 5.2 illustrates how this might operate:

Weekly Income €	Existing Liability €	Proposed Liability €
352	0	0
362	9.4	1.4
372	9.8	2.8
382	10.2	4.2
392	10.6	5.6
402	11	7
412	11.4	8.4
422	11.8	9.8
432	12.2	11.2
440	12.52	12.32
442	12.6	12.6
443	12.64	12.64

A similar step effect occurs with the health contribution levy. Where income is less than €26,000 there is no liability to the health contribution levy. However, a liability of €1,040 (4%) arises where the income increases to €26,001. We consider that this is inappropriate and that moves should be made to eliminate the step effect. The issue could be resolved in a similar way to that proposed in relation to the employee PRSI step effect.

Our recommendation below in relation to the health contribution levy is that it should be integrated into the income tax system but that this move should not begin until fiscal conditions improve. In the meantime, consideration might be given to eliminating the impact of the health contribution levy step effect through an approach of the type outlined above.

The estimated cost of eliminating the PRSI and health contribution step effects as outlined above is about €180 million in a full year.

Recommendation 5.18
The step effect in PRSI and the health contribution levy should be eliminated.

3.1.13 Health contribution levy and the national training levy

Health contribution levy

Collection of the health contribution levy is undertaken by the Revenue Commissioners in the context of collecting income tax and PRSI (including the national training fund levy). Unlike social insurance, the health contribution levy does not confer any entitlement to benefit on the contributor. It does not form part of the social insurance fund. We consider it to possess many of the hallmarks of a tax.

The previous Commission on Taxation considered whether the health contribution levy and other 'special levies' should be brought within the general tax system. In general, that Commission was opposed to the concept of earmarked taxes or special levies and recommended that they should be integrated into general taxation. The Commission on Social Welfare (1986) and the Expert Working Group on the

Integration of Tax and Social Welfare (TWIG 1996) also concluded that the health contribution levy was a form of taxation.

The health contribution levy is paid to the Department of Health and Children to help fund health services. The contribution and its application to the benefit of the Department of Health and Children has established a clear and discrete source of finance for the health services. It may also create a link in the public mind between the provision of health services and the need to finance them and this linkage may make payment of the contribution more acceptable than the payment of other taxes into the general Exchequer.

Abolishing the health contribution levy would remove a form of taxation from within a social insurance system and would simplify the PRSI system.

It would greatly rationalise PRSI classes[6] through the removal of one PRSI class and 15 subclasses which exist solely for the purposes of the health contribution levy and administrative procedures would be simplified because two systems are being amalgamated.

The base[7] for income tax purposes differs from the base for the health contribution levy and pursuing this option will lead to winners and losers. Abolishing the levy and integrating it into the general taxation system would address the anomaly where recipients of particular social welfare payments and medical card holders are completely exempt from payment of the health contribution levy regardless of the level or source of their income. Such individuals (and those with earnings of less than €26,000, who are also exempt from the health contribution levy) would face an increased liability. Those who might gain from such a move include those who avail of deductions which are available against income tax but not against the health contribution levy. These issues would have to be taken into account in any move to a new system.

We recommend that this should not take place until fiscal conditions improve sufficiently to allow an orderly transition to a new structure. However, we consider that the health contribution levy should be abolished and integrated into the general taxation system.

Recommendation 5.19
The health contribution levy should be integrated into the income tax system.

National training fund levy

The national training fund levy is collected as part of PRSI contributions by employers. The fund is administered by the Department of Enterprise, Trade and Employment to support a broad range of employment training initiatives. The fund is

[6] According to the Department of Social and Family Affairs, there are currently 11 classes and 34 subclasses in the PRSI system. One class (K1) and eight subclasses exist solely for the purposes of the health contribution levy exemption limit. A further seven subclasses exist solely for the category of individuals who are specifically exempt from payment of the health contribution levy (medical card holders, individuals getting a social welfare widow/widower's pension, a one-parent family payment or a deserted wives benefit or allowance). Abolition of the health contribution levy would result in the removal of these subclasses and significantly reduce the complexity of the PRSI system. The administrative burden for employers, the Revenue Commissioners and the Department of Social and Family Affairs would also be reduced.

[7] Annex 8 outlines the different bases for income tax, income levy, PRSI, the health contribution levy and the national training levy.

resourced by a levy on employers of 0.7% of reckonable earnings in respect of employees in Class A and Class H employments (approximately 76% of all insured employees) and is incorporated into the employer's share of PRSI. Unlike the health contribution levy, it is not a liability of the employees. Like the health contribution levy, the training levy does not confer any entitlement to benefits on the contributor. Contributions to the fund amounted to about €440 million in 2008.

We consider that (similar to the health contribution levy) the national training fund levy should be more appropriately regarded as a tax. It should be abolished in the longer term but employer PRSI should be retained at its current rate. The main benefit of this is that it would help to simplify the PRSI system by removing elements i.e. the training fund levy and the health contribution levy, which are essentially taxation measures. Alternative approaches to funding the national training fund will be required.

Recommendation 5.20
The National Training Fund Levy should be abolished and a different approach to funding the National Training Fund should be put in place.

Report of Special Group of Public Service Numbers and Expenditure Programmes

Changes to the PRSI System
The *Social Insurance Fund* derives its income from PRSI contributions and it funds the various social insurance payments made by the D/SFA. The Fund has run surpluses since 1997 but this trend has reversed in the last year and a half as PRSI receipts decreased and social insurance payments have increased substantially.

Payments are set to increase significantly in future years as the age profile of the population increases. The accumulated surplus on the fund will run out in 2010 with deficits forecast thereafter. Changes are required to ensure the future sustainability of Exchequer finances in general and the Group considers that changes are required to ensure adequate revenue to the Fund and the State. Further work should be done on examining;

- changes in the rates and structures;
- elimination of exemptions;
- base widening; and
- simplification of the current complex rating structure.

This work should be completed in time for consideration in *Budget 2010*.