

**SUPPLEMENTARY SUBMISSION  
TO  
COMMISSION ON TAXATION**

THE SCHOOL OF PHILOSOPHY  
AND  
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FOREWORD

Following the School's Submission to the Commission on Taxation in October 1980, the authors have carried out some further work aimed at clarifying the principles propounded. This Supplementary Submission is therefore a broad restatement of the earlier work, and addresses itself:

- (a) To the need for fundamental reform of our taxation system, and
- (b) To how such reform might be realised in practice.

## 1. THE NEED FOR FUNDAMENTAL REFORM

### 1.1. The Growing Burden of Taxation

In recent years the proportion of the Nation's annual production of wealth taken by Central Government in taxation has grown dramatically. Table 1 shows the rapid rise from 19.3% of GDP in 1960, to 28.2% in 1970. By 1978 taxation equivalent to 31.7% of GDP was absorbed by Government to help meet its expenses.

This rapid growth in the weight of taxation is a symptom of imbalance in the economy in that total productive output is not keeping pace with the demands of taxation on that output. Thus, each year taxation absorbs a larger portion of the whole than it did the year preceding.

Though the rapid growth in the overall tax burden should be of concern in itself, tax revenues are still far from sufficient to meet present expenditure commitments which are accelerating at an even faster rate. Consequently, the borrowing requirement has now become a major element in Government finances and pressures to reduce it can

only be met by transferring the burden onto current taxation.

However, evidence would suggest that the existing burden of taxation is already too great and is, in fact, forcing more and more productive efforts onto the margin of production (i.e. the margin of viability), where they are under the constant threat of being pushed over the edge into bankruptcy.

As a result, the weaker industrial units depend increasingly on the State for grants, loans, subsidies and other so-called 'incentives'. In this strange cycle, mounting costs of State intervention and handouts are funded out of ever-rising taxes - levied currently, or postponed until a later time as in borrowing - whose impact necessitates still more intervention.

In this situation, clearly, there seems to be no natural limit to the growth of government expenditure, and hence, the taxation required to service that expenditure. However, there is a point at which the capacity of productive undertakings to bear taxation reaches saturation. The evidence of recent years would suggest that this point is being transgressed.

## 1.2. Added Value and Taxation

The weight of taxation at the macro level has its counterpart on the micro level in the amount of tax borne by individual productive units. The extent of this corporate tax burden is not limited merely to Corporation Tax, but is the aggregate of all the various taxes levied in any particular case, regardless of their method of assessment.

This can best be illustrated by reference to the concept of added value. Added value, or net product, is a good measure of new wealth creation in any business, and it is only from added value that taxation, inter alia, can be met. A properly drafted statement of added value and its distribution reveals the full extent of taxation borne. For example, Figure 1 shows the added value statement actually published by Arnott & Company, Dublin, Limited, in their latest Annual Report: it states explicitly that 37% of added value was allocated to Government by way of PAYE and PRSI, VAT and Corporation Tax.

Usually, by far the greater portion of the burden is income tax in the form of PAYE and PRSI.

However, many published statements totally misrepresent the amount of taxation borne by featuring only the Corporation Tax payable. This widespread practice masks the reality by including taxes on employment with 'payments to employees'.

The scale of this deception may be appreciated by reference to the relative amounts raised from each of these categories in 1978: Corporation Tax contributed only 5% of total tax revenues; while employment-based taxation came to 45% of the total. Nonetheless, both have their source in added value, although neither are levied with respect to it as a basis of assessment.

A characteristic feature of added value creation throughout any economy is that - expressed as added value per head - it varies enormously from one undertaking to another and from one industry sector to another. This observable fact has far-reaching implications in the realm of taxation because differential added value must give rise to differences in ability to bear taxation. Consequently, assessing taxation by reference to bases other than added value must inevitably lead to side-effects whose extent are incalculable.

(c) That such incomes will, for any particular occupation or profession, tend to a common level.

In practice, these principles exert themselves when any attempt is made to place taxes on the employee's real earnings. The result is a transfer of this burden to the employer by a demand for higher wages to compensate for pay packet losses. In the case of taxes imposed on commodities, the employee will seek more money to enable him to pay the consequent higher prices.

Adam Smith put it simply: every tax upon the wages of the labourer is inevitably shifted to his employer. Table 3 illustrates the truth of this on the macro scale. During the period since 1960 gross wages and salaries of employees in the economy have steadily risen as a proportion of GNP. However, net wages and salaries have remained remarkably stable over the same period, vividly demonstrating how the increasing burden of employment-based taxation has tended to be shifted onto employers.

Our proposition is that employment-based income tax is a wholly arbitrary contrivance whose imputed incidence is at variance with the facts. The notion

of gross earnings only serves to perpetuate the myth that it is the employee who bears the tax, the employer merely acting as tax collector. Such a view leads to the erroneous conclusion that high wages are a major cause of inflation and unemployment. On the contrary, far from wages being the culprit, inflation and unemployment are encouraged by taxes on employment.

#### 1.4. The Clue to Fundamental Reform

Pay-as-you-earn is perhaps the most misconceived and pernicious form of taxation ever invented. Whenever people work harder to improve their earnings, income tax bites deeper. At higher levels of management, where people are well paid for the responsibility they carry, income tax makes a nonsense of payrises and creates absurdly inflationary salary figures which bear little relationship to the actual sums received.

The disincentive effects of a progressive income tax and the malignancy this engenders are undoubtedly one of the main barriers to improving efficiency and raising productivity.

By coming between the natural need to contribute and the reward commensurate with the fulfilment of that contribution, employment-based income tax acts as a wholly divisive and destructive force in society.

However, this need not be. In our original Submission (October 1980)\* the bold move taken by Len Ferns was described: he observed the evil effects of PAYE at first hand, saw them for what they were, and then took full advantage of the situation. The aggregate of PAYE and PRSI represents a heavy tax on employment which, quite apart from inflating the costs of employment, creates a barrier to productivity. It is a simple but powerful psychological barrier, induced by the thought of deductions.

Len Ferns' achievement was to remove this barrier entirely by intimately relating contribution to reward, thereby releasing the hidden resources in both quantity and quality of labour. His secret is to pay workers the full amount agreed, and "gross up" this net amount for tax purposes.

\* See Appendix A.

## 2. GUIDELINES FOR REFORM

### 2.1. Taxation as a Corporate Impost

The essence of the Stylewear initiative is that the incidence of taxation has been shifted away from earnings to its true point of incidence: the corporate resources of the undertaking.

To understand this, it is necessary to recognise that the added value, or net product, of any undertaking is composed of two basic parts: that which goes to the employees as real earnings, and the remainder which stays with the employer. It is the remainder which represents the corporate resources, and out of which all charges on the undertaking must be paid, (see Figure 2).

For example, out of this remainder the employer has to meet all charges for depreciation, renewals and maintenance. Corporate resources have to fund research and development; and if the undertaking borrows, the bank charges likewise fall on these resources. And the biggest single charge which attaches to these resources is invariably taxation. Anything left after all these charges have been met, is the profit.

Thus, the concept of added value provides a simple method of determining the primary division of the product between the real earnings of employment and corporate resources. The various charges on the undertaking met from corporate resources are clearly a secondary distribution of added value. Taxation is one such secondary charge and therefore, in principle, has nothing to do with the earnings of employment.

The ability of an undertaking to bear taxation, i.e. its taxable capacity, must obviously be related to the extent of its corporate resources. As is evident from added value statements so far published, corporate ability to meet taxation is only reflected to the extent that Corporation Tax is payable. However, part of the taxable capacity is at present absorbed through PAYE and PRSI by way of taxation on earnings. To the extent that these charges could be reduced, the portion of taxable capacity so released would need to be taken into the revised assessment of corporate ability to meet taxation.

Thus, one has to understand that the concept of taxable capacity is related to the corporate entity rather than the individual.

In general, it may be said that the individual dependent for his livelihood on wages and salaries has no taxable capacity. The truth of this is demonstrated by the PAYE system in which income tax is levied on employees but paid by the employer who actually holds the capacity to pay.

Taxable capacity may therefore be equated with corporate resources, and defined as that part of the added value remaining in the business after wages and salaries have been paid net of tax. It is a measure of an undertaking's ability to meet the demands of taxation but does not in itself determine the amount of taxation to be paid.

Thus, our proposition is that taxation should fall on corporate resources as enhanced by relief of taxation at present levied on employment.

## 2.2. Taxation and the Margin of Production

One of the main problems with the present tax régime is that taxation, broadly speaking, is levied regardless of taxable capacity. Mention of this was made in Section 1.2: Added Value and Taxation; but the following illustrations from actual cases give a better insight to the magnitude of the inequity.

It is a simple matter to calculate the corporate resources of the Bank of Ireland and CIE from Figures 4 and 2 in our Submission of October 1980: \* these are £115.1 million and £0.5 million, respectively. And from Figure 1 of this Supplementary Submission, the corporate resources of Arnott and Company amount to about £7.5 million. The aggregate of current taxation borne on the corporate resources of the Bank of Ireland was £29.4 million, or about 25% of taxable capacity, thus leaving 75% of corporate resources with the Bank to meet other claims. The taxation charge due from Arnott and Company last year came to about 68% of taxable capacity (equivalent to the 37% of added value shown in Figure 1). CIE, however, with corporate resources of £0.5 million in 1978,

\* See Appendix B.

could obviously only pay the aggregate taxation charge of £24.3 million (4860% of corporate resources generated by CIE!) out of the grant furnished from the Exchequer.

Since all taxation is met from corporate resources anyway, reform must recognise this and also the fact that the extent of corporate resources differs widely from one undertaking to another and from one industry sector to another, and levy taxation accordingly.

Theoretically, the extent of corporate resources, and therefore taxable capacity, varies from zero to infinity: Figure 6 in our original Submission illustrates the general pattern.\* The point at which taxable capacity approaches zero defines the margin of production. At this point the full product will be allocated to employees as earnings.

In practice, all businesses now in production must have some taxable capacity in order to meet the cost of employment, including as it does a substantial element of taxation.

\* See Appendix C.

Nonetheless, this concept of the margin of production marks the starting point in determining taxable capacity. A marginal activity may therefore be considered as one which, by the nature of its location and its activities, produces only sufficient to pay its costs of employment. There is little or no margin to allow for asset replacement, etc. Putting it simply, the added value will be allocated to employees, and to the Government as far as taxation on earnings is concerned.

One of the reasons why this concept of the margin of production is important is because it is at the margin that new productive undertakings first make their appearance. Such businesses are vulnerable in the extreme: any adverse shift in the terms of trade immediately threatens their existence, while in times of general economic boom their number multiplies rapidly. If prosperity is sustained, profit margins begin to appear, and new entrants take their place at the margin.

Since the only incomes produced at the margin of production are wages and salaries, employment-based taxation inflates the cost of operating a

marginal enterprise by the amount of taxation imposed. Consequently, certain combinations of activity and location must be precluded from otherwise gainful production - and hence, employment creation - reduced, as they must be, to submarginal status.

Taxation reform must seek to accord with the general pattern of taxable capacity in the economy. It is especially important that enterprises at the margin be encouraged as far as possible by relief of all forms of taxation which, by definition, should not be imposed. In practice, this might mean that new businesses in a start-up situation might be allowed every chance to become viable and established by not being subject to any taxation charges for, say, the first two years of operation. After such time has elapsed they could then be assessed for taxation on the basis of their newly emerging taxable capacity.

### 2.3. Principle and Practice

The added value concept is the fundamental instrument by which the principles expounded here may be made practicable. It is a simple though powerful technique for isolating productive capacity, to which taxable capacity must obviously be related.

What the economy needs in order to prosper, and what Government must encourage in order to secure adequate taxation revenues, is growth in added value. Without added value, employees can receive no wages, employers can make no profits, and Government can collect no taxes. Production, as represented by added value, must come first. Obviously, the greater the added value generated, the more wealth there is for distribution, and the larger does the true tax base become.

This can be expressed in scientific terms: the added value generated by an industry needs to approximate more closely to the full potential of the given location. Taxation on earnings distorts this process by retarding the growth in added value. Once this is lifted, the added

value generated per employee moves ahead at a remarkable rate, in the direction of the full potential of the particular location. This principle has been fully verified at Stylewear Limited in Merseyside.

The opportunities for Irish industry in this regard are enormous, most especially for the so-called traditional sectors. For years these labour intensive industries have gradually been crippled by the high taxation of employment, greatly retarding their ability to generate vital added value. The resulting uncompetitiveness has inevitably led to factory closures. So bleak do the prospects for these industries now appear to be, that even the IDA seems resigned to the view that their vast potential for employment-creation is no longer applicable to Irish economic conditions. These conditions are the progeny of the tax system, and it is reform of the tax system which holds the key to harnessing the hidden potential.

The essence of our proposals is that taxation should be levied simply by applying a fixed percentage rate to corporate resources. However, before this could be made practical a number of relevant points need to be taken into consideration.

Firstly, studies would show that the magnitude of corporate resources - expressed on a 'per capita' basis - tends to accelerate sharply as one moves towards the centre of economic and community development, (Figure 6 in Appendix C. illustrates the pattern.)

It is unlikely, therefore, that applying a single rate of tax across the whole economy would satisfactorily reflect these enormous variations in taxable capacity. Rather, a somewhat higher rate of tax would seem justified on the corporate resources of those businesses at the centre of economic and community development.

This would be perfectly in keeping with the idea of returning to the community that which the community has created. After all, added value reflects community rather than individual values: thus, high added value invariably gives rise to high taxable capacity and hence high tax liability. The rate at which tax is levied should therefore be such as to accord with this simple economic fact.

However, differential added value per head within an industry sector may in practice be attributable to factors whose effects would not allow a corresponding differential in tax liability between the individual undertakings to emerge.

For example, good site location will give rise to higher added value than poor location; however, the increase in corporate resources resulting from this factor\* will invariably be absorbed in higher rent and rates. Thus, these secondary charges tend to be highly progressive in their incidence and, when met, little or nothing of the rise in corporate resources will be left to meet a higher taxation charge.

Similarly, high added value per head may be due in part to use of additional capital equipment which may therefore require higher interest and depreciation charges. Again, these charges will tend to absorb some of the increase in taxable capacity.

By assessing tax liability with respect to the full extent of corporate resources these secondary charges (with the exception of taxation itself) would not be allowed to erode the tax base by being 'tax deductible' - as, for example, interest payments are at present. However, depreciation charges may need to be considered as a tax deductible item so as not to penalise asset replacement.

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\*It is assumed that rent for the use of land, or its equivalent, constitutes part of added value and hence, corporate resources. This point is discussed in the original submission.

The foregoing would seem to imply that a single rate of tax should apply to all undertakings within the same industry sector, at the very least; a variation in the tax rate applicable only to those well placed sectors at the top of the taxable capacity league. There is another factor which is a major cause of high added value in individual undertakings: management efficiency. While the differential due to this factor may seem at first sight to be taxable - sadly, it is under the present tax system - it needs to be understood that productive efficiency should not be penalised.

In other words, the principle of receiving rewards commensurate with contribution applies as much to a corporate entity, industry sector, or indeed a whole nation, as it does to the individual dependent for his livelihood on wages. Just as employees should not in principle be penalised when they work harder to increase their earnings, so management efficiency must likewise not be penalised by a greater taxation charge on corporate resources; nor should lethargy and waste be rewarded by lower taxation.

This might be difficult to incorporate into a reformed system of taxation: clearly, some means of

achieving objectivity in tax assessments would be needed so that management efficiency would be encouraged. It is suggested that national norms of added value for each industry sector might provide a basis for achieving a reasonable degree of objectivity in individual tax assessments, as well as providing the data required to construct appropriate rates of tax.

Finally, as a prerequisite to enhancing corporate resources with that portion of taxable capacity currently absorbed by taxes on employment, it would be necessary to dissolve the present differential in allowances for personal taxation. In other words, two persons with identical 'gross earnings' for doing the same work will, under the present tax system, probably have different take-home pay - perhaps significantly so. In a reformed system where employees no longer have any taxable capacity it would seem important that this difference in pay-packet earnings be eliminated as far as possible.

Initially, this could be achieved by substituting cash payments for such items as child allowances, etc. In so far as life insurance premiums, mortgage interest, and the like, are allowable, these could be paid net of the amount of tax saved.

In this way, earnings derived from employment will reflect work done rather than personal circumstances like the number of dependents one has. These latter can be catered for more properly independent of the tax collecting machinery.

In the long term, as rising productivity and output generate higher tax free earnings, and hence a higher standard of living throughout the community, the need for many of these so-called tax-expenditures might largely disappear.'

#### EPILOGUE

We live at a time when confusion, and often times bewilderment, seems to permeate much of the nation's economic life. While the symptoms are all too plain to see, the cure - if there be just one - continues to elude us. Whatever the solution it must of necessity derive from an understanding of the causes.

Today, for example, a man's natural will to work is blunted by the effects of a cruel taxation system. The consequences of this are far-reaching: low productivity, uncompetitiveness, factory closures, unemployment, high taxation, and inflation, to name but the more obvious effects.

When the ideas behind this vicious system are examined they are clearly found to be fundamentally unsound. Is it any wonder then why a system of taxation, founded on such ideas, has grown progressively into the enormously complex and bureaucratic structure it is today; and why the annual attempts to shore-up the shaky edifice only seem to make matters worse?

The ideas put forward in this and the earlier submission seek to retrace the steps of recent times and, by reference to first principles, lay the groundwork afresh for an entirely new approach to our thinking on taxation - an approach, moreover, that seems to overflow with potential. Certainly the Stylewear experiment, and others like it, lends powerful support to this promise.

These ideas may well seem radical, simplistic, and far removed from today. Yet, is this not the measure of how far we have drifted? The immediate challenge is to put these same ideas to the test by subjecting them to rigorous examination in public and private debate.

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## APPENDIX A

### The Stylewear Tax-free Pay Scheme

*(For the full story of the Stylewear initiative refer to the article "How Tax Prevents Prosperity" in MANAGEMENT TODAY, April 1979, by John Allen and Emile Woolf).*

Mr. Len Ferns is Managing Director of Stylewear Manufacturing Limited in Birkenhead, Merseyside. His firm produces trousers and employs some 250 persons. In a bold move in 1973, Mr. Ferns took the initiative of liberating his workforce from the burden of income tax. He accomplished this by quite simply making all gross incomes become net take-home pay. Thus, every worker was paid in full according to the going rate, while Ferns 'grossed-up' the employees' earnings for tax purposes.

The immediate result was that productive output increased by twenty per cent within seven days, and this increase more than compensated for the rise in taxation charges the company had to bear. The Inland Revenue has no objection to this scheme as long as the employer shoulders the burden of paying tax at the rates required. Indeed, Stylewear's tax bill jumped by over forty per cent, but all this, and more, has been funded out of the boost in productivity. Nor have the firm's margins suffered. On the contrary, Ferns claims that his margins are far better than those customary in the trade; while his employees received far more in wages - in return for higher productivity - than they can obtain in a similar position elsewhere.

Surprisingly, he also found that those with higher personal allowances did not in the least resent the fact that single employees working at the same rate were now taking home the same pay. On the contrary, the new arrangement revealed a natural recognition that there was a rate for every job, and each employee actually received the multiple of that rate appropriate to his or her output. The new system removed the erosion of that rate previously caused by PAYE, most especially for those without dependents. Staff saw, in effect, the removal of a series of false differentials and the establishment instead of what must genuinely be the only differential - relative productivity.

Today, in 1981, his business (in complete contrast to most of the trade) is still booming and the high levels of production sustained.



APPENDIX B  
(Continued)

Figure 4

ADDED VALUE AND ITS DISTRIBUTION  
BANK OF IRELAND GROUP: YEAR ENDED 31st MARCH 1980

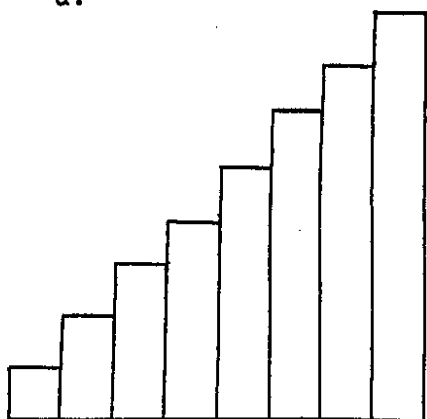
<u>Creation</u>	IR£m	IR£m
Total Income: Net interest and commissions	115.8	
Income from investments	48.7	
Other income	<u>29.0</u>	
		193.5
Deduct: Cost of goods and services bought in from outside suppliers		<u>24.3</u>
Total Added Value		<u>169.2</u>
<u>Distribution</u>		
(a) Employees: Net wages, salaries, pensions and other benefits		54.1
(b) Government: Corporation Tax - current	3.6	
Income Tax (PAYE)	17.3	
Social Welfare - employees	1.9	
- employer	3.7	
VAT , rates, etc.	<u>2.9</u>	
		29.4
(c) Capital: Interest on loan stock, etc.	2.1	
Minority interests	0.4	
Dividends	<u>8.2</u>	
		10.7
(d) Provision for bad debts:		13.7
(e) Reinstatement,		
Development and Expansion:		
- Depreciation on Group Assets	2.9	
- Depreciation on Leased Equipment	28.4	
- Retained for investment, incl. deferred Corporation Tax	<u>30.0</u>	
		61.3
Total Added Value		<u>169.2</u>

Note: Corporate Resources defined as Added Value  
less net benefits to employees.

APPENDIX C

Figure 6.

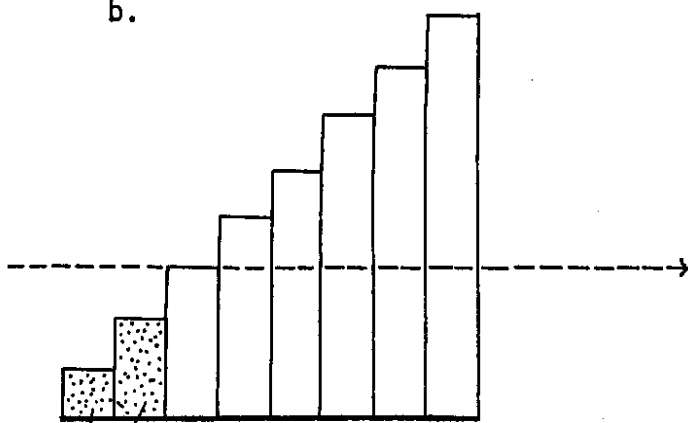
a.



Differential Added Value per head for:

1. Different industry sectors.
2. Different undertakings within the same industry sector.

b.

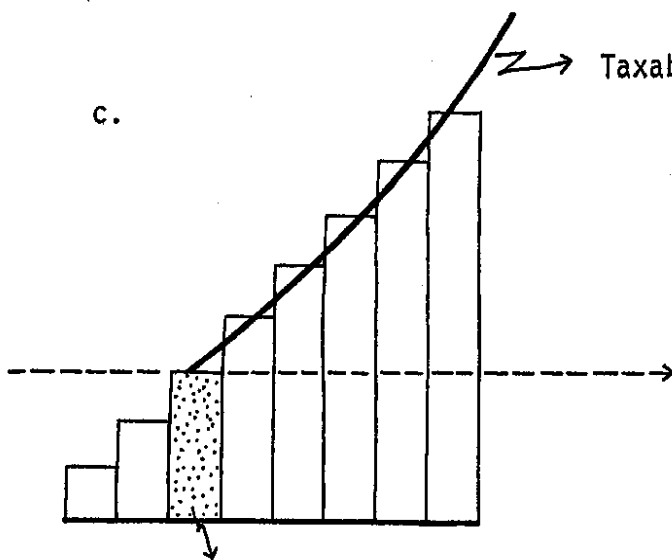


Minimum Added Value per head necessary to stay in production.

- = Allocated to employees
- = Margin of Production
- = Taxable Capacity approaches zero

Submarginal - not in production

c.



Taxable Capacity

Margin of Production;  
Taxable Capacity = 0

Marginal Enterprise