EXAMINATION OF BUDGET 2007 - INCOME TAX MEASURES USING THE POVERTY IMPACT ASSESSMENT GUIDELINES.

Background

The Office for Social Inclusion located in the Department of Social and Family Affairs issued new guidelines during 2006 which are to be used by Government departments for assessing policies and programmes at design, implementation and review stages in relation to the likely impact that they will have or have had on poverty and on inequalities which are likely to lead to poverty, with a view to poverty reduction. The guidelines, which replace the previous poverty proofing guidelines issued by the Department of Social and Family Affairs, are known as poverty impact assessment guidelines.

The primary aim of the poverty impact assessment process is to identify the impact of the policy proposal on those experiencing poverty or at risk of falling into poverty so that this can be given proper consideration in designing or reviewing the policy. It is not intended that all policies be fundamentally transformed so that they are explicitly targeted at the disadvantaged but rather that any possible negative impacts be identified and measures put in place to ameliorate such impacts. Likewise, it is important that positive impacts are identified so that they can be enhanced if possible.

Considerations to bear in mind

The Social Welfare measures in Budget 2007 will accrue mostly to those at the lower end of the income distribution who, without such measures, would experience a significant deterioration in their income in relative terms.

The ESRI SWITCH model was utilised to analyse the impact of the combined effect of social welfare changes, and the tax changes contained in Budget 2007. This tax-benefit model is based on the ESRI's 'Living in Ireland Survey', a survey of national incomes, which includes employees, pensioners, unemployed persons, farmers, self-employed, etc. The model calculates the percentage change in disposable income across each income decile as a result of Budget 2007. This is done by comparing the 2006 tax and welfare regimes using projected 2007 incomes against the 2007 tax and welfare regimes using 2007 projected incomes.

The model (see Figure 1 following) shows that the most significant net income gains are to those on the lowest incomes, while much smaller gains accrue to those in middle to high-income brackets. This analysis reflects the progressive nature of Budget 2007, which sees those dependent on welfare getting the greatest gains. From a distributional point of view, Budget 2007 ensures that the lowest income groups gain progressively more (from welfare payments) than the higher income groups, who contribute progressively more to the cost of public service provision. The overall distributional effect is similar to that achieved in the last four Budgets.

Budget 2007 targets over 55% of the resources in the personal income tax package to those on low incomes, as well as the elderly, widowed persons and those with a disability or who care for a person with a disability.

Those at the lower end of the income distribution will also benefit from taxation measures if they become exempt. In this regard, the entry point to taxation has been increased in Budget 2007 (as it has been in every Budget since 1997).

The statutory minimum wage came into effect in April 2000 (at £4.40/€5.59 per hour). Since then, the value of the minimum wage has been increased four times by almost 37% in all and now stands at €7.65 per hour. Budget 2006 increased the value of the basic personal tax credit and the employee tax credit to ensure that the minimum wage in its annualised form was placed outside the tax net. This remains the position at end 2006 and a key aim of the Government's income tax policy continues to be met. Budget 2007, through substantial increases in the basic personal tax credit and the employee tax credit, raises the level of the entry point to taxation for the single employee aged under 65 years by almost 13% from €15,600 in 2006 to €17,600 in 2007. This increase is sufficient to ensure that a wage of over €8.65 per hour in its annualised form will not be liable for income tax. In addition, the employee weekly threshold for liability to PRSI is increased from €300 to €339 thus ensuring that no PRSI liability will arise on such a wage. The Health Levy threshold is also being increased by €40 from €440 per week to €480 per week which will ensure that a person earning up to almost €25,000 per annum will not be liable for the levy.

The impact on poverty is one criterion for assessing the Budget. There are other acknowledged goals and targets such as increasing economic efficiency, rewarding effort and enterprise and encouraging capital accumulation, all of which improve economic welfare generally and are additional to the fundamental role of budgeting revenue and expenditure. Also, in terms of looking at the Budget's impact on poverty, it is necessary to consider not only the income tax measures which it contains but also: -

(a) the additional increment of social inclusion spending provided for through specific Budget measures. In Budget 2007, the value of these is about €1.6 billion for 2007; and

(b) the aggregate value of social inclusion spending across all Government programmes which is provided for annually through the Estimates process and the Budget. It is estimated that in 2007, this spending, including social welfare payments, will amount to about €26.9 billion, an increase of €2.8 billion compared with 2006 and representing over 48% of gross total expenditure on public services.

These expenditures may be particularly relevant to, and of benefit to, those in the lower income categories referred to below who do not pay tax and are, therefore, not affected by tax changes.

Early Childcare Supplement

The Early Childcare Supplement introduced in Budget 2006 and the social welfare measures announced in Budget 2007, together with the income tax changes to the extent that they apply, will have a significant beneficial impact for those on low incomes. The year 2007 is the first year in which the Early Childcare Supplement will apply for a full year. As such, qualifying earners will receive an additional €250 in 2007 for each child under six years of age compared with supplement payments received in 2006. The payment will continue to be made separately from, and in addition to, Child Benefit. It is not means-tested and is exempt from income tax. As a flat rate payment, the supplement is of greater significance for those on lower incomes whether they are inside the tax net or already outside it.

Poverty Impact Assessment of Income Tax Measures

The 2007 Budget income tax package was screened in accordance with the requirements outlined in Stage 1 of the Poverty Impact Assessment guidelines prepared by the Office for Social Inclusion. Having regard to significance of the income tax package in terms of overall national policy, the change it will bring about in an existing policy and its relevance to some or all of the groups[1] identified in the National Action Plan against Poverty and Social Exclusion as vulnerable groups, it was necessary to carry out a poverty impact assessment in accordance with Stage 2 of the guidelines.

Consultation

A pre-Budget consultation process was undertaken, whereby organisations and individuals made written and oral submissions to the Minister for Finance and to the Department of Finance regarding the nature, extent and focus of income tax changes in Budget 2007. Specifically in relation to personal income tax, the Minister received of the order of 50 written pre-Budget submissions from a wide range of organisations and individuals who either represent many of the vulnerable groups outlined above or who put forward proposals which would be of benefit to such groups.

In addition, issues identified as being relevant to the Budget income tax package were discussed by the Tax Strategy Group as part of its schedule of meetings which take place every year as part of the annual Budget and Finance Bill cycle.

What is the primary objective of this policy/programme/expenditure proposal?

It is the established and generally accepted view that the fundamental role of taxation is to raise revenue to fund the provision of services by the State. In providing these services the State has its various policy objectives, including tackling disadvantage. In looking at the effect of changes to income tax it needs to be borne in mind that what is at issue is the change in tax paid by income earners - those in lower income categories do not pay income tax. For 2007, it is estimated that about 20% of those returning income for tax purposes will pay approximately 78% of all income tax. Accordingly, changes to income tax affect some sections of the population more than others and do not affect those on low incomes not paying tax.

Who are the target groups and how will the proposal reach those groups?

An Agreed Programme for Government contains a commitment to *"keep down personal and business taxes in order to strengthen and maintain the competitive position of the Irish economy"*. In addition, the Programme provides that *"we will concentrate the resources available to us on ....delivering further real improvements to pensioners and people on low incomes"* and that "*over the next five years our priorities with regard to personal taxation will be to achieve a position where all those on the national minimum wage are removed from the tax net, and to ensure that 80% of all earners pay tax only at the standard rate*."

These statements are governed by an over-arching commitment in the Government Programme regarding the need to pursue responsible fiscal policies and to maintain the public finances in a healthy condition.

These priorities are also reflected in Partnership Agreements.

Therefore, the priority in relation to the Budget income tax package is to ensure that those on the minimum wage do not pay income tax, to maintain the policy of a low tax burden, particularly for those in lower paid employment, and to increase the incentive to work. In this way, the target groups of the policy are those on low incomes, including the elderly and, to the extent that

[1] Women, children and young people, older people, people with disabilities, members of the travelling community, prisoners and ex-prisoners, people experiencing rural disadvantage, people experiencing urban poverty, migrants and ethnic minorities.

resources permit, the generality of taxpayers who stand to benefit from a further lowering of the income tax burden thereby further increasing the incentive to work. It is expected that Budget 2007 will target over 55% of the resources in the personal income tax package towards those on low incomes, as well as the elderly, widowed persons and those with a disability or who care for a person with a disability.

The target groups will be reached through measures designed to change the personal income tax system which are announced on Budget day and subsequently provided for in law through the Finance Bill.

What are the differences within the target group/between the target groups which might lead to them benefiting from the policy/programme in different ways and how could these be addressed?

The differences between the target groups may be identified by reference to levels of income and differences in personal circumstances, including age. Relative to the generality of taxpayers, the tax system provides more favourable tax treatment to those aged 65 or over. The circumstances of different target groups are addressed through adjustment of reliefs which focus on those groups. A clear example of this is the Age Exemption limits system which targets relief at those aged 65 or over.

Consider what data is available within own organisation, other departments or agencies or from alternative sources. Identify data or indicators against which progress can be measured.

The key data on which decisions in relation budget income tax changes are made are provided using the tax forecasting computer model[2] operated by the Revenue Commissioners. This model can provide information on how tax changes impact on individual income earners or groups of earners or all income earners as well as estimates of the costs of such changes. In addition, the Income Tax Policy Section of the Department of Finance operates a computer system which enables changes to the personal income tax system to be modelled and which provides data on net income changes for different categories of income earner. The ESRI SWITCH model may also be utilised to analyse the income distribution effects of the combined impact of Budget tax and social welfare changes.

Besides the use of computer models, information derived from the Parliamentary process, from representations, from pre-Budget meetings and submissions may be taken into account in the formulation of the Budget income tax package.

What type of impact on poverty would the proposal have, in particular for each of the vulnerable groups identified in the National Action Plan against Poverty and Social Exclusion as vulnerable groups?

As indicated earlier, it needs to be borne in mind that what is at issue is the change in tax paid by income earners. The tax system as currently structured can only impact on earners in the vulnerable groups mentioned to the extent that they receive income and pay tax. However, in relation to the vulnerable groups identified for priority attention in the Government Programme, that is, the lower paid and the elderly, by increasing levels of net income and increasing the

[2] The model is based on an extract from the main computer record of the latest complete historical income distribution data for a specified tax year. That extract is used as the "*base year*" data for the model. It contains details of incomes, tax credits and allowances and tax liabilities (including nil liabilities) of PAYE and self employed income earners at individual level.

reward for work, the Budget's income tax changes help to prevent people in such groups from falling into poverty.

Budget 2007, through substantial increases in the basic personal tax credit and the employee tax credit, raises the level of the entry point to taxation for the single employee aged under 65 years by almost 13% from €15,600 in 2006 to €17,600 in 2007. As such, over €338 per week of earnings is made free of tax. In addition, the exemption limits from income tax for persons aged 65 and over are being increased by an annual sum of €2,000 single/€4,000 married bringing them to €19,000 and €38,000. Over six years, these limits have increased in value by 76%. It is estimated that in the six years 2002 to 2007 the cost of living as measured by the Consumer Price Index will have increased by about 23%.

Does the Budget income tax package…..

i) ***help to prevent people falling into poverty?***

ii) ***reduce the level (in terms of numbers and depth) of poverty ?***

iii) ***ameliorate the effects of poverty ?***

Changes to direct taxation will not directly impact on those in the lowest income households, who are already by and large outside of the tax net. Budget 2007 removes a further 97,300 taxpayers from the tax net. This brings the total number of income earners outside the tax net to over 845,900 or 38.2% of income earners. The highest ever proportion of income earners are expected to be out of the tax net in 2007 despite the fact that in 2007 there is expected to be more such earners than ever before. For a married couple, with one income (PAYE) and a carer in the home, over €581 per week is made free from tax while for a single PAYE person over €338 per week of income becomes free from tax.

Altogether, the Budget 2007 income tax measures help to improve the welfare of people on lower incomes. Removing additional lower income earners from the tax net helps to increase disposable incomes at this level. Similarly, the increases in the basic personal and employee (PAYE) tax credits and in the health levy threshold will mean that the circumstances of certain workers on lower incomes, and who continue to be in the tax net, will be improved. Furthermore, increases in the standard rate band will ensure that all those with incomes at or below the average industrial wage will have a liability to tax at no more than the standard rate of 20%.

iv) ***have no effect on poverty ?***

By taking people out of the tax net, Budget 2007 will help to improve disposable incomes.

v) ***increase poverty ?***

The income tax changes do not increase poverty.

vi) ***contribute to the achievement of the NAPS targets ?***

Insofar as persons defined as consistently poor are within the tax net, the Budget income tax measures will contribute to progress towards the overall NAPS target to reduce poverty among that section of the population. The income tax system is not modulated on a regional basis.

vii) ***address inequalities that might lead to poverty ?***

viii) ***as proposed, reach the target groups ?***

By taking more of the lower paid out of the tax net and by reducing tax at lower levels of income, the income tax measures address inequalities that might lead to poverty. To the extent that target groups are income earners, the income tax measures will impact positively on their welfare. The tax changes will remove 97,300 from the tax net and will reduce the burden for other low income households. In addition, the increase in the health levy threshold will benefit 81,600 persons.

Improvements to the Family Income Supplement, the increase in Child Benefit, the new Early Childcare Supplement, and the increases in other social welfare payments, achieve balance in the distributional effects of this Budget. Responsibility for poverty impact assessment of social welfare expenditure measures lies with the Department of Social and Family Affairs.

The basis for this assessment is the analysis by both the Department of Finance and the Revenue Commissioners of the distributional impact of the changes to income tax in Budget 2007. Examples 1 - 12 in Annex A show the net income changes for a range of incomes and family types including the impact of Child Benefit, the Early Childcare Supplement and FIS. Figures 2 – 4 below show the net income gains for Single, Married One Earner (Two Children) and Married Two Earners (Two Children) on full rate PRSI as a result of the Budget personal income tax measures and the change in the PRSI threshold and ceiling. In addition, the SWITCH model has been used to assess the distributional impact of the tax and social welfare measures in the Budget.

If the proposal has the effect of increasing the level of poverty, what options might be identified to ameliorate this effect?
Not applicable**.**

If the proposal has no effect on the level of poverty, what options might be identified to produce a positive effect?
Changes to income tax affect some sections of the population more than others and do not affect those not paying tax. As already indicated, it is necessary to take the social welfare measures in Budget 2007 into account as well as taxation measures and direct social inclusion spending planned for 2007.

Will this proposal be adopted?
Yes. It is intended that the Budget 2007 income tax package will be adopted subject to the measures being approved in the Finance Bill process by the Oireachtas.

How will its impact on poverty be monitored?
The impact of Budget income tax measures on the lower paid insofar as it removes earners from the tax net and reduces the tax burden for other low income households is monitored on a continuing basis as part of the annual Budget and Finance Bill cycle.

Figures

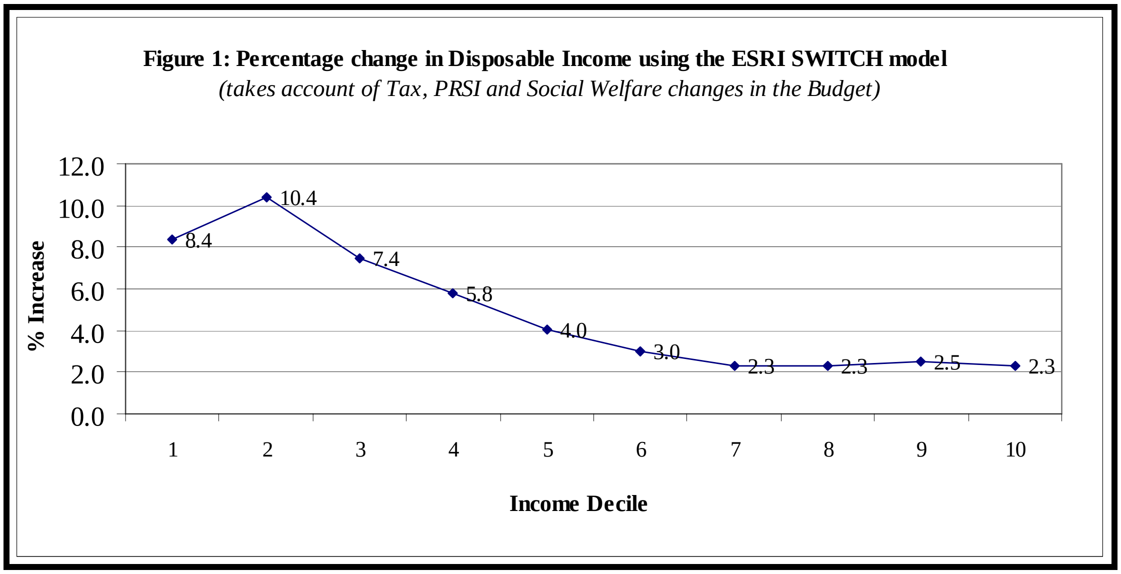
Figure 1: Percentage change in Disposable Income using the ESRI SWITCH model
(takes account of Tax, PRSI and Social Welfare changes in the Budget)
% Increase
12.0
10.0
8.0
6.0
4.0
2.0
0.0
8.4
10.4
7.4
5.8
4.0
3.0
2.3
2.3
2.5
2.3
1
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8
9
10
Income Decile

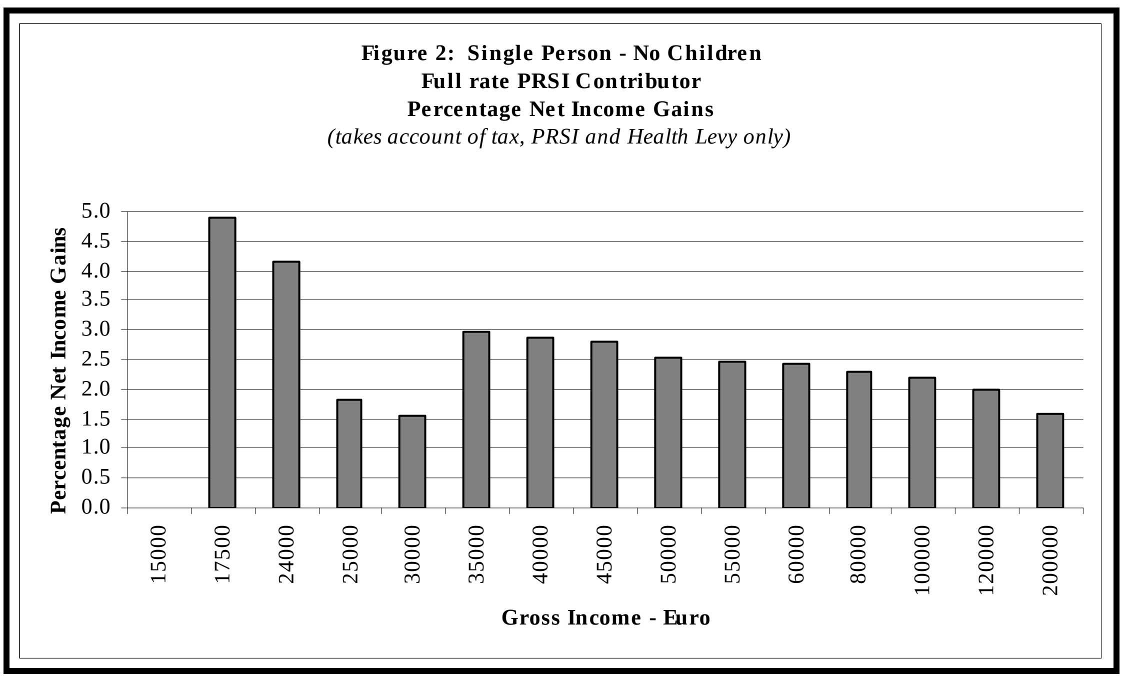
Figure 2: Single Person - No Children
Full rate PRSI Contributor
Percentage Net Income Gains
(takes account of tax, PRSI and Health Levy only)
Percentage Net Income Gains
5.0
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
15000
17500
24000
25000
30000
35000
40000
45000
50000
55000
60000
80000
100000
120000
200000
Gross Income - Euro

Figure 3: Married Couple One Income - Two Children
Full rate PRSI Contributor
Percentage Net Income Gains
(takes account of tax, PRSI and Health Levy only)

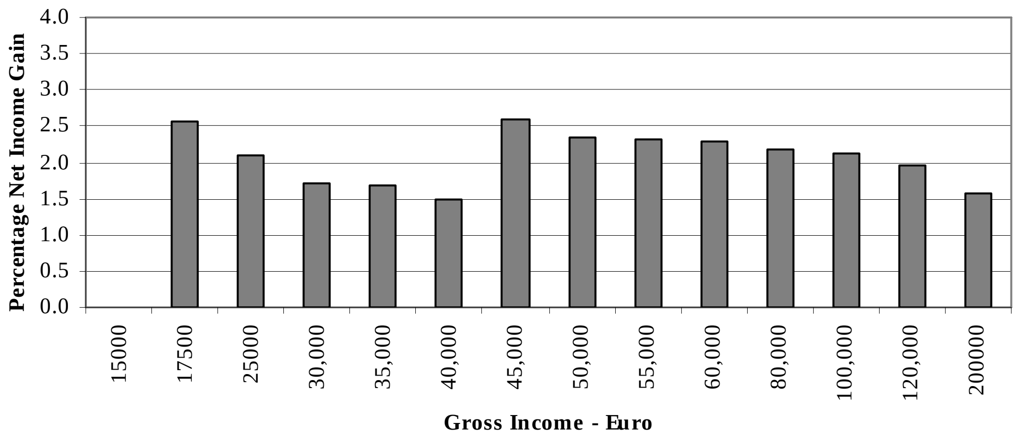

Figure 4: Married Two-Earner Couple - Two Children
Full Rate PRSI Contributors
Net Income Gain
(takes account of tax, PRSI and Health Levy only)