

## Annex B

### EXAMINATION OF BUDGET 2006 - INCOME TAX MEASURES USING THE NATIONAL ANTI POVERTY STRATEGY GUIDELINES.

#### Background

The National Anti Poverty Strategy Unit of the Department of Social and Family Affairs has issued guidelines ('the NAPS guidelines'), which are to be used by Departments for poverty proofing policy proposals. The primary aim of the poverty proofing process is to identify the impact of the policy proposal on the poor so that this can be given proper consideration in designing policy. It is not intended that poverty proofing would require that all policies be fundamentally transformed so that they are explicitly targeted at the disadvantaged.

#### Considerations to bear in mind

The Social Welfare measures in Budget 2006 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<sup>1</sup> model was utilised to analyse the impact of the combined effect of social welfare changes, including the introduction of the new Early Childcare Supplement, and the tax changes contained in Budget 2006. 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 2006. This is done by comparing the 2005 tax and welfare regimes using projected 2006 incomes against the 2006 tax and welfare regimes using 2006 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 highly progressive nature of Budget 2006, which sees those dependent on welfare getting the greatest gains. From a distributional point of view, Budget 2006 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 three Budgets but significantly greater in impact.

Budget 2006 targets roughly half 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 2006 (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 restores the position achieved after Budget 2005 whereby the minimum wage in its annualised form was

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<sup>1</sup> This publication includes the result of analyses conducted by the Department of Finance using SWITCH, the tax/benefit model developed at the ESRI. The model is described in *Simulating Welfare and Income Tax Changes*, by T. Callan et al., Dublin : ESRI, 1998. No responsibility for the analyses in the present document is accepted by the ESRI or by the authors of the model software.

removed from taxation. This ensures that a key aim of the Government's income tax policy continues to be met for the second Budget in a row. In addition, the employee weekly threshold for liability to PRSI is increased from €287 to €300 thus ensuring that a single PAYE person on the minimum wage faces no tax or PRSI charge whatsoever.

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 2006, the value of these is about €1.6 billion for 2006; 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 2006, this spending, including social welfare payments, will amount to about €23.5 billion, an increase of €2.8 billion compared with 2005 and representing over 46% 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 new Early Childcare Supplement and the social welfare measures announced in the Budget, together with the income tax changes to the extent that they apply, will have a significant beneficial impact for those on low incomes. The supplement will be worth €1,000 per year for each child under six years of age and will be made separately from, and in addition to, Child Benefit. It will not be means-tested and will be exempt from income tax. As a flat rate payment, the supplement will be of greater significance for those on lower incomes whether they are inside the tax net or already outside it.

### **Poverty Proofing of Income Tax Measures**

#### **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 2006, it is estimated that 21% of those returning income for tax purposes will pay over 77% 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.

The particular policy priorities in this Budget driving the changes to the income tax regime are: 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.

Does it . . .

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

By increasing levels of income and increasing the reward for work, the Budget's income tax changes help to prevent people in the target groups from falling into poverty. As indicated above, Budget 2006 fulfils the agreed policy goal of exempting the minimum wage from income tax - for a single PAYE person, the first €300 per week 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 €500 single/€1,000 married bringing them to €17,000 and €34,000. Over five years these limits have increased in value by over 57%. It is estimated that in the five years 2002 to 2006 the cost of living as measured by the Consumer Price Index will have increased by about 16%.

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 2006 removes a further 55,000 taxpayers from the tax net. This brings the total number of income earners outside the tax net to over 741,000 or 35.9% of income earners. The highest ever proportion of income earners are expected to be out of the tax net in 2006 despite the fact that in 2006 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, the first €530 per week is made free from tax while for a single PAYE person the first €300 per week of income becomes free from tax.

Altogether, Budget 2006 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 pay 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 2006 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 55,000 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 72,300 persons.

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

**And what is the rationale and basis of the assessment (data/information) behind each of these proposals?**

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 2006. 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 including the Early Childcare Supplement in the Budget.

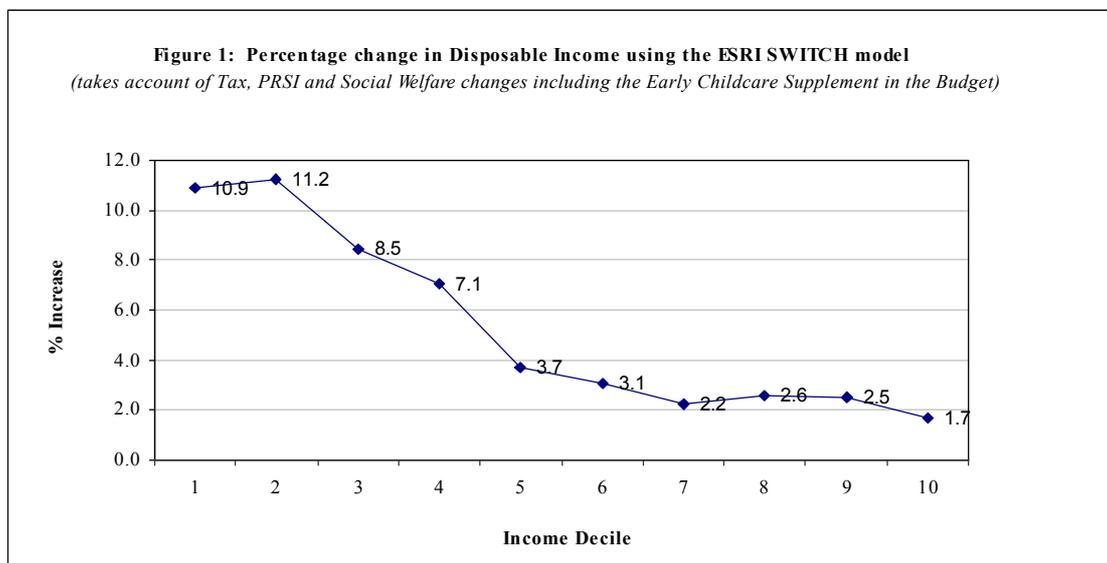
**If the proposal has the effect of increasing the level of poverty, what options might be identified to ameliorate this effect?**

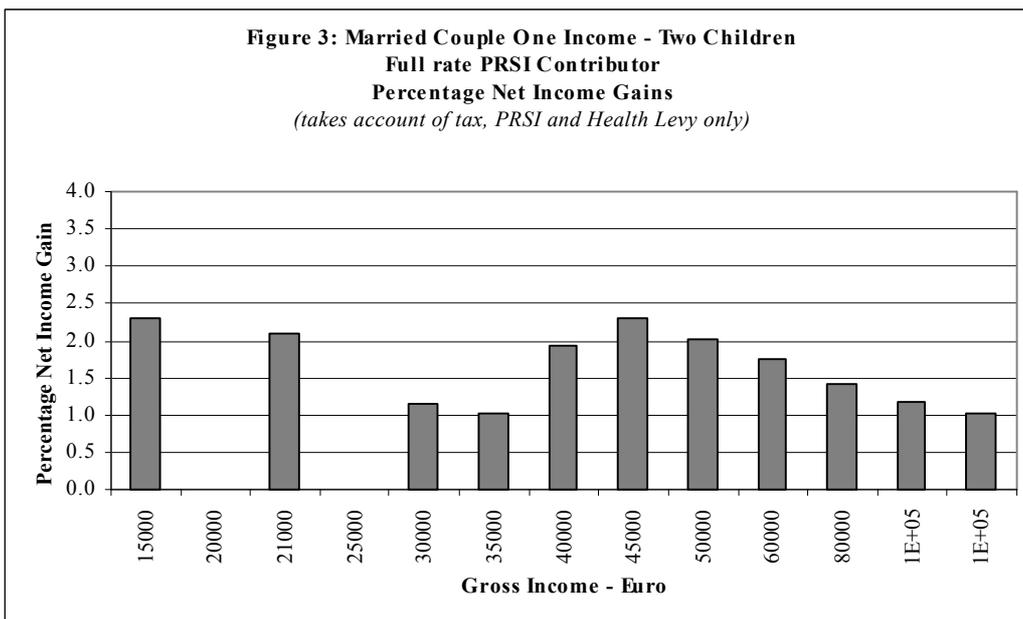
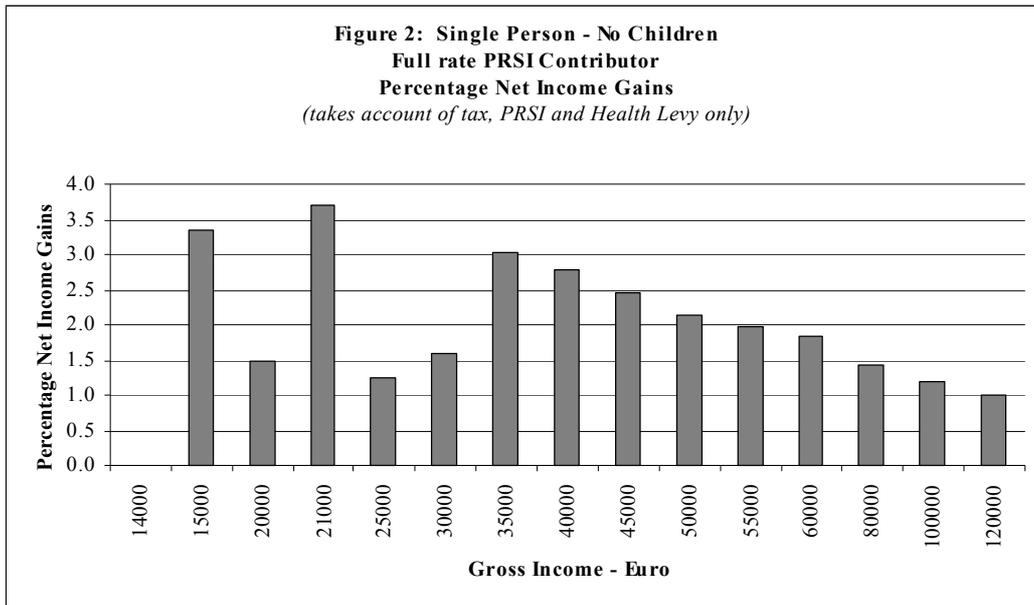
Not applicable.

**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 2006 into account as well as taxation measures and direct social inclusion spending planned for 2006.

**Figures**





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

