Income Tax

1. Consideration of any changes to personal income tax in Budget 2009 will take place within the context of the substantial worsening fiscal and economic conditions and the overall structure of the 2009 Budget having regard to these conditions.

Fiscal and Economic Context
2. The overall economic and fiscal context has been set out in the paper *Economic Framework for the Budget* (TSG 08/04). The Government's response to the worsening situation has been to bring Budget Day forward to 14 October 2008.

Programme for Government:
3. The Programme sets out guiding principles for economic and fiscal policy for the lifetime of the Government which include commitments to

- *"….. operate a responsible fiscal policy characterised by broad budget balance and a declining debt burden."* and

- *"Keep the overall tax burden low and implement further changes to enhance the rewards for work while increasing the fairness of the tax system."*

These principles of fiscal responsibility, fairness and keeping the overall tax burden low inform the development of any Budget measures to be considered.

4. With regard to personal taxation, *An Agreed Programme for Government* states:

"Subject to the controlling economic and fiscal framework, the Government will implement the following specific approach to tax:

- *"Our first priority remains low and middle income earners – therefore our first task will be to use tax credits and bands to keep low income earners out of the standard rate band and average earners out of the higher band.*
- *PRSI, as currently devised, is not a fair tax as it is not levied on incomes above 48,800*[1]*. Consequently, it is most lightly borne by those on the highest incomes. To eliminate this inequity, we will abolish the PRSI ceiling for full rate payers and reduce the rate at which this tax is levied from 4% to 2% over the lifetime of the Government. We will also reduce the rate of PRSI paid by the self employed to 2% from 3%. These moves will eliminate remaining inequality in the income tax system and enhance its progressive nature. The Social Insurance Fund will be reimbursed by the Exchequer for the cost of this reform.*
- *Once these commitments are met, any additional resources will be targeted at further enhancing the rewards of work. Specifically, we are committed to reducing the standard rate of income tax to 18% and the higher rate of income tax to 40% over the lifetime of the Government if economic resources allow."*

[1] Increased to €50,700 in Budget 2008

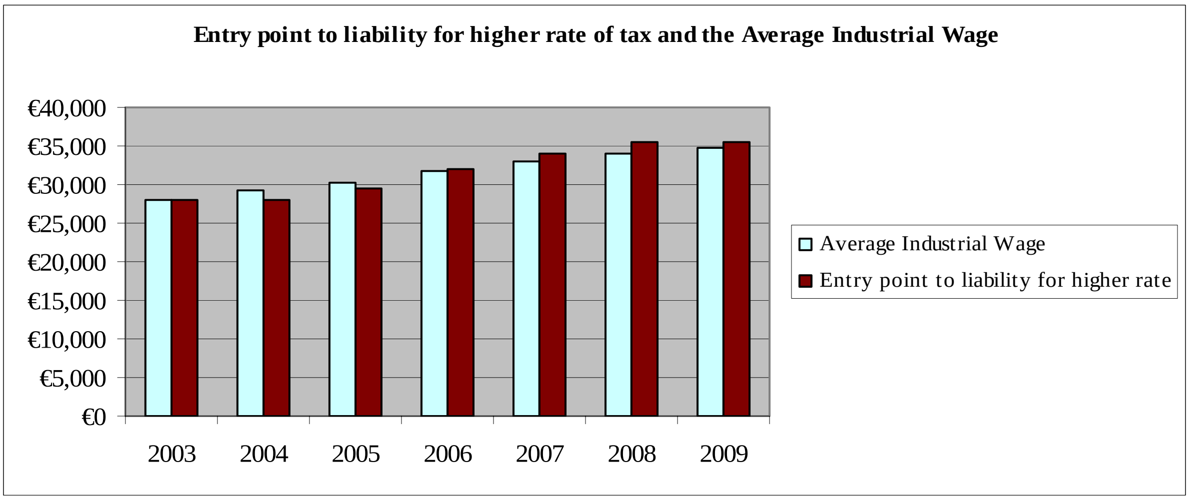
The Government Programme also includes a commitment in relation to mortgage interest relief which was met in Budget 2008 with the ceiling for first-time buyers and first-time buyers who bought a house in the past seven years, increasing from €8,000 to €10,000 for single people and from €16,000 to €20,000 for married couples or widowed persons.

Reforms and developments in recent years

5. Over the last number of years significant reforms have been introduced to the personal income tax system. Tax rates have been reduced considerably and the standard rate band widened. The move from allowances to a more equitable tax credits system was completed in 2001.

6. After Budget 2008, it was estimated that when one takes account of the earners whose liability to tax at the higher rate is fully offset by their personal credits, the percentage of earners who actually pay tax at the higher rate was just over 20%.

7. In addition, after Budget 2008, the position was that a single person on PAYE was not liable for the top rate of tax until his or her income reached €35,400 or 104% of the estimated average industrial wage for 2008[2]. The following chart indicates the position in this regard over the last six years and estimates the position for 2009 assuming no change in the standard rate band.



8. Increases in the main personal tax credits over the course of the last ten Budgets, in conjunction with the reduction in the standard rate, have resulted in the single PAYE employee paying no income tax where income is at or less than €352 per week, or €18,300 per annum. This is equal to 104% of the national minimum wage annualised. Married PAYE one-earner couples with a carer in the home pay no income tax where income is at or less than €614 per week, or €31,950 per annum; married two-earner PAYE couples pay no tax where income is at or less than €704 per week, or €36,600 per annum.

[2] Estimated at approximately €34,000 (using latest data from CSO for average industry earnings in Production, transport, craft and other manual workers sector). Note: the figures for 2007, 2008 and 2009 are derived using slightly different methodologies than the figures for 2003 – 2006 as the CSO has changed its method for calculating AIW since mid-2007.

Budget 2008 income tax changes

9. The Budget 2008 income tax package continued to build on the position first achieved in Budget 2005 whereby the minimum wage is placed outside of the tax net. The employee tax credit was increased from €1,760 to €1,830. All employees benefited from this increase. The personal credit was also increased from €1,760/€3520 (single/married) to €1,830/€3660 (single/married). These changes together ensured that the minimum wage remained well outside the tax net in 2008. In fact the current entry point is equivalent to an hourly wage of just over €9/hour. Progress was also made on widening the standard rate band. The single band was increased by €1,400 to €35,400. The married one-earner band was increased by €1,400 to €44,400 and the married two-earner band was increased to €70,800 with transferability restricted to €44,400.

10. The home carer tax credit was increased for the first time since it was introduced in 2000 from €770 to €900.

11. The age exemption limits for those aged 65 and over were increased in Budget 2008 from €19,000 per annum for a single person and €38,000 per annum for a married couple, where one or both are aged 65 and over, to €20,000 per annum and €40,000 per annum respectively. Over the last seven Budgets, the limits have increased by 85%.

12. The minor credits were also increased in Budget 2008. The incapacitated child credit was increased from €3,000 to €3,660 per annum, equivalent to the value of the married personal credit. The blind person's credit was increased in line with the increase in the personal credit, from €1,760 single and €3,520 per annum married to €1,830 and €3,660 per annum, respectively. The widowed person's credit was increased from €550 to €600 per annum. The widowed parent credit was also increased from €3,750 (Year 1), €3,250 (Year 2), €2,750(Year 3), €2,250 (Year 4), €1,750 (Year 5) to €4,000, €3,500, €3,000, €2,500 and €2,000 per annum, respectively.

13. The Health levy threshold was increased from €480 per week (€24,960 per annum) to €500 per week (€26,000 per annum).

14. The combined cost of the 2008 income tax measures was estimated at Budget time at €582 million in a full year.

15. The main changes are summarised in the Table below.

	2007	**2008**	**Increase**	**Percentage Increase**
Tax Credits	**€**	**€**	**€**	**%**
Personal Credit	1,760	1,830	70	4.0
Employee (PAYE) Credit	1,760	1,830	70	4.0
Home carer credit	770	900	130	16.8
Standard Rate Bands				
Single	34,000	35,400	1,400	4.1
Married one earner	43,000	44,400	1,400	3.3
Married two-earner	68,000	70,800*	2,800	4.1

* transferability limited to €44,400.

16. Budget 2008 removed an estimated 39,100[3] income earners on lower income from the tax net. It was estimated after the Budget that more than 878,100[4] income earners (37.6% of all income earners) were outside the tax net. This compares with a figure of 380,000 (25% of all income earners) in the 1997/98 tax year.

17. In summary, the position in 2008 is that a person earning the minimum wage is well outside the tax net and a person earning the average industrial wage is well outside liability to tax at the higher rate. In international terms, the latest OECD data relating to the year 2007 indicate that for a single worker, married one-earner couple with two children or a married two earner couple with two children on average earnings, Ireland has the lowest tax wedge[5] in the EU in all categories and the lowest in the OECD for the married categories.

Distribution of Income Earners

18. The following table sets out the projected distribution of income earners taking account of the measures introduced in Budget 2008, as well as revised 2008 figures and a distribution on a pre-Budget 2009 basis. The revised 2008 figures and pre-Budget 2009 figures are derived from the Revenue model using the most recent base tax year (2005) for which data are available and taking account of forecast increases in employment and earnings in 2009[6]. The figures show that in 2009, on a no change basis:

- 40,100 **fewer** income earners would be exempt from tax
- 6,400 **more** income earners would pay tax at the standard rate
- 61,900 **more** income earners would pay tax at the higher rate.

Tax year	Exempt (Standard rate liability fully covered by credits or Age Exemption Limits)		Paying tax at the standard rate (including those whose liability at the higher rate is fully offset by credits)		Higher rate liability NOT fully offset by credits		All cases
	Number	%	Number	%	Number	%	
Pre-Budget 2008	838,900	35.9	950,655	40.7	547,955	23.4	2,337,600
Post Budget 2008	878,140	37.6	954,930	40.8	504,530	21.6	2,337,600
Revised Tax year 2008	908,500	38.2	1,006,900	42.3	464,200	19.51	2,379,600
Pre-Budget 2009	868,400	36.1	1,013,300	42.1	526,100	21.8	2,407,800

[3] Post Budget 2008 estimate from the Revenue model using a base year 2004
[4] Post Budget 2008 estimate from the Revenue model using a base year 2004
[5] The tax wedge is defined as income tax plus employee and employer PRSI minus cash transfers from the State as a proportion of gross wages.
[6] These macroeconomic forecasts for employment and earnings could be subject to revision

***Fiscal Position* XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX**

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20. In this context, a number of alternative scenarios are set out below for discussion. These costings are based on the Revenue model. Costs/yields can vary depending on the precise nature of the measure and whether they relate to individual items or a package of items where combination effects can arise between credits, bands and rates. An income tax Ready Reckoner will be available shortly on the Department of Finance website7.

No Change (Scenario 1)

21. As outlined above, the Government Programme outlines priorities relating to the tax treatment of low and middle income earners. As a result of the measures introduced in Budget 2006, 2007 and 2008 and the forecast wage growth for 2009 over 2008, the position is the these priorities will continue to be met in 2009, even if there is no change to the income tax system. i.e. those on the minimum wage would remain exempt from tax while those on average earnings would not pay tax at the higher rate. However, there would be fewer exempt and more people paying tax at both the standard and higher rate.

Indexation of Credits to CPI (Scenario 2)

22. The last time there was a significant deterioration in the fiscal position was in 2002/03. In Budgets 2003 and 2004, the emphasis was to safeguard the position of workers on low incomes by providing for modest increases in the PAYE credit.

23. Assuming taxes could be raised elsewhere to finance an income package, one scenario would be to use these resources on indexing the value of the personal and the employee tax credits in line with CPI. This would increase the personal and the employee tax credit from €1,830 to €1,885 at a cost of approximately €150 million in 2009 and €200 million in a full year. This would increase the entry point to the tax net to €18,850 and would increase the number of income earners exempt from tax from 36.1% to 37.1% in 2009. This package would also reduce the percentage of income earners in 2009 whose liability for tax at the higher rate is not offset by their credits from 21.8% on a pre-Budget basis to 21.5%.

Indexation of Credits and Bands in line with CPI

24.XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXX. To maintain the value of the bands and main credits[8] relative to forecast (CPI) inflation (3.0% for 2009 over 2008) would cost about €425 million in a full year and €310 million in 2009. These changes would reduce the percentage of income earners in 2009 whose liability for tax at the higher rate is not offset by their credits from 21.8% on a pre-Budget basis to 20.5%. In addition, the percentage of income earners exempt from tax would increase from 36.1% to 37.1% in 2009.

Revenue raising measures

7 www.finance.gov.ie

8 Personal Credit and Employee (PAYE) Credit

Income Tax

25. The following paragraphs will outline for purpose of illustration a number of revenue raising measures from an income tax perspective. It is important to bear in mind that studies from both the European Commission and the OECD show that significant increases in income tax could have a much greater negative impact on economic growth than increases in consumption taxes or property taxes. However, as the taxation on labour in Ireland is low by international standards, it is arguable that there is scope to increase taxation in a way that will generate revenue while having a limited negative impact on both labour demand and labour supply.

Standard rate (Scenario 3)

26. A 1% point increase in the standard rate would yield approximately €465 million in 2009 and €645 million in a full year. Such a measure would bring an additional 40,200 income earners into the tax net in 2009 and reduce the entry point to the tax net to €17,428, bringing the minimum wage back into the tax net.

27. However, an increase in the combined value of the credits by €24 would be sufficient to ensure that the minimum wage would remain outside the tax net. Such a measure would cost approximately €35 million in 2009 and €45 million in a full year.

Higher rate (Scenario 4)

28. A 1% point increase in the higher rate would yield approximately €200 million in 2009 and €305 million in a full year.

Income Levy (Scenario 5)

29. An alternative approach would be the introduction of a 1% income levy, applying to all income earners: this would yield approximately €755 million in 2009 and €1,085 in a full year. To obtain that yield, however, by introducing such a measure would impose a tax on minimum wage earners, social welfare recipients and old age pensioners. There would inevitably be pressure to address this problem. The introduction of a threshold of €26,000 in line with the health levy would address this problem but give rise to others – see below. It would also reduce the yield to €638 in 2009 and €920 in a full year[9].

The Health Levy

30. <u>There are no commitments in the Government Programme in relation to the health contribution levy.</u> Apart from exempt categories, such as those with entitlement to a medical card including those aged 70 and over, the levy is payable at 2% by all income earners with income in excess of the €26,000 threshold on their entire income. In addition, where a person's income exceeds €1,925 per week (€100,100 per annum), an extra 0.5% is charged in respect of the income in excess of €1,925 per week (or €100,100 per annum). In 2008 the health levy is expected to yield about €1.3 billion[10].

31. The health levy threshold was increased in Budget 2008 from €480 per week to €500 per week, while the annual threshold increased from €24,960 to €26,000. Once liability arises, the levy is payable at 2% on a person's entire income including the portion below the threshold. This has been described as the "step effect" and it can lead to circumstances where an increase in gross pay for a person with income just below the threshold results

[9] A lower threshold such as €18,300, to exempt the minimum wage, would yield €704m in 2009 and €1,015m in a full year.

[10] Based on an estimate prepared by the Revenue tax costing model.

in a reduction in his/her net take home pay. A €1 increase in annual pay can lead to a reduction of €10 in net pay per week or approximately €520 per annum. Where in any tax year, a person's income is below the annual threshold, any amounts paid as a result of them having exceeded the weekly threshold may be reclaimed.

32. To address the issue of the 'step effect' mentioned above by turning the lower threshold into an allowance would cost an estimated €760 million in a full year. To increase the value of the threshold relative to the expected increase in the CPI for 2009 over 2008; i.e. by about €780 to €26,780, would cost an estimated €17 million in a full year. The cost of maintaining the threshold in place at its present level i.e. continuing to exempt incomes which are below the threshold value, is estimated at €290 million in a full year. Restoration of the levy to those aged 70 or over would yield about €40 million in a full year while abolishing it for those aged 65 to 69 would cost the Exchequer about €35 million in a full year.

33. An increase in the health levy from 2% to 4% for all earners would yield approximately €1,175 million in 2009 and €1,705 million in a full year. Such a measure would impact on 1.3 million income earners.

34. Each 1% increase in the higher rate of the health levy (on incomes exceeding €100,100) would yield approximately €100 million in 2009.

Conclusions

35. The scenarios are analysed in Appendix A in relation to distribution changes against the latest figures for 2008 and against the pre-Budget estimates for 2009. This demonstrates how many more or fewer cases will:

- be exempt from tax,
- be paying tax at the standard rate when previously exempt and
- have a liability to tax at the higher rate not fully offset by credits.

36. It can be seen from the distributions that in the majority of options explored the number of earners exempt from tax is likely to be greater in 2009 than in 2008 and in all cases the numbers paying tax at the higher rate is likely to increase.

37. When considering possible income tax options it is important to bear in mind the possible impact each option will have on the supply and demand for labour. For example, a significant increase in income tax, either through a direct measure such as changes in tax rates or through fiscal drag can have an impact on labour demand (increasing the cost of employing workers) or labour supply (increasing the marginal tax rate and giving rise to high replacement rates).

38. However, as outlined earlier in the paper, Ireland has the lowest tax wedge in the EU for single, married one-earner with two children and married two earner with two children couples earning the average wage (or 167% of the average wage in the case of a married two-earner couple – with a 100%:67% split). For each option examined in this paper, including the Revenue raising measures, and assuming no changes in 2009 relating to other countries, the resulting tax wedge for the categories outlined above was examined (Appendix B). The tax wedge in Ireland for all categories examined is likely to continue to be the lowest in the EU and lowest in the OECD for the married categories.

39. A summary comparison sheet of costs/yields of the different scenarios discussed in this paper and other potential scenarios is attached at Appendix C.

40. The Tax Strategy Group may wish to consider.

September 2008