Income Tax

1. Consideration of any changes to personal income tax in Budget 2007 will take place within the context of the overall structure of the 2007 Budget package and the personal income tax commitments in *An Agreed Programme for Government.* Subject to ratification, the provisions of the draft new partnership agreement "*Towards 2016"* will also be relevant insofar as they refer to taxation.

An Agreed Programme for Government:

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

"The parties remain committed to the achievement of the taxation objectives set out in Action Programme for the Millennium. 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.*
- *to use the potential of the tax credit system to effectively target changes and to pursue further improvements in the income tax regime if economic resources permit."*

It further states that:

"We will keep down taxes on work in order to ensure the competitiveness of the Irish economy and to maintain full employment".

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.

New Partnership Agreement

3. The current draft new Partnership Agreement *"Towards 2016"* refers to taxation only in a general way in the context of setting out a number of key macroeconomic principles viz.

> *"Building an equitable tax system which encourages economic growth so as to ensure employment growth ……."*

and

> *"Maintaining a sound Budgetary position which encourages economic growth so as to ensure employment growth and continuing improvements in living standards for all" .*

In addition, the draft Agreement outlines strategies which will be pursued within the Government's budgetary and economic framework including:

"Taxation Policy designed to maintain and strengthen the competitive position of the economy, foster improvements in productive capacity, economic and social development, and equity, while maintaining a sound fiscal stance………"

Sustaining Progress Commitments

4. The previous Social Partnership Agreement, *Sustaining Progress*, (part 1, paragraph: 3.3.2) contained the following:

"the scope for changes in the tax system to facilitate economic growth and employment creation will continue to be considered, as will incentives for those on low incomes to take up employment. At the same time, the need to pursue responsible fiscal policies and to maintain the public finances in a healthy condition will guide all taxation decisions…."

"to the extent that there is any scope for personal tax reductions, progress will continue to be made over the three budgets contained within the lifetime of this Agreement towards removing those on the minimum wage from the tax net, moving toward the target where 80% of all earners pay tax at not more than the standard rate."

Measures delivered since 1997

5. Over the last nine Budgets the Government has introduced significant reforms with regard to taxation policy.

Tax rates

The standard rate and top rate of income tax have been reduced by six percentage points each since 1997. The standard rate of tax currently stands at 20% and the top rate stands at 42%.

Widening the Standard Rate Band

The standard rate band has been widened considerably. The bands currently stand at:

Single	€32,000
Married One-Earner	€41,000
Married Two-Earner	€64,000 with transferability limited to €41,000.

After Budget 2006 it was estimated that 31.9% of income earners were paying at the top rate of tax.

In 1997 a single person was liable to tax at the higher rate on an income of approximately 90% of the value of the average industrial wage as it stood then. Currently, the same person is not liable for the top rate of tax until his or her income reaches €32,000 which is 101% of the estimated average industrial wage for 2006[1]. It is estimated that by end-2006 the average industrial wage will have increased in real terms[2] by over 20% since 1997.

[1] estimated at approximately €31,700

[2] growth in the average industrial wage discounted for inflation as measured by growth in the CPI.

Credits

The move to tax credits was completed in Budget 2001. Tax credits are more equitable than allowances in that they have the same value for all those who pay tax regardless of their level of income. The value of the main personal credits i.e. the Personal and Employee credits, has increased significantly in recent years which has had the effect of moving significant numbers of income earners out of the tax net altogether.

Increases in the main personal allowances/tax credits over the course of the last nine Budgets have resulted in the single PAYE employee paying no income tax where income is at or less than €300 per week, or €15,600 per annum. This is equal to 100.5% of the 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 €530 per week, or €27,600 per annum; married two-earner PAYE couples pay no tax where income is at or less than €600 per week, or €31,200 per annum.

Budget 2006 income tax changes

6. The Budget 2006 income tax package restored 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 €1,270 to €1,490. All employees benefited from this increase. The personal credit was increased by €50 to €1,630. These changes together ensured that 100.5% of the minimum wage was exempt from income tax. Progress was also made on widening the standard rate band. The single band was increased by €2,600 to €32,000. The married one-earner band was increased by €2,600 to €41,000 and the married two-earner band was increased to €64,000 with transferability restricted to €41,000.

7. The age exemption limits for those aged 65 and over were increased in Budget 2006 from €16,500 per annum single and €33,000 per annum to €17,000 per annum and €34,000 per annum respectively. Over the last five Budgets, the limits have increased by almost 57%.

8. The minor credits were also increased in Budget 2006. The incapacitated child credit was increased to €1,500 per annum. The blind person's credit was increased from €1,000 single and €2,000 per annum married to €1,500 and €3,000 per annum respectively. The widowed person's credit was increased from €400 to €500 per annum. The widowed parent credit was also increased from €2,800 (Year 1), €2,300 (Year 2), €1,800 (Year 3), €1,300 (Year 4) and €800 (Year 5) to €3,100, €2,600, €2,100, €1,600, €1,100 per annum, respectively.

9. The Health levy threshold was also increased from €400 per week (€20,800 per annum) to €440 per week (€22,880 per annum).

10. The combined cost of the 2006 income tax measures was estimated at Budget time at €887 million in a full year.

11. Budget 2006 removed an estimated 55,000[3] income earners on lower income from the tax net. It is estimated that after the Budget more than 741,000[4] income earners (over 35.9% 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.

12. In summary, the position in 2006 is that a person earning the minimum wage is outside the tax net and a person earning the average industrial wage pays no tax at the higher rate. In international terms, the latest OECD data for 2005 indicates that for the single worker on the average earnings, Ireland has the lowest tax wedge in the EU and one of the lowest in the OECD.

Distribution of Income Earners

13. The following table sets out the distribution of income earners as presented in Budget 2006, as well as revised 2006 figures and a distribution on a pre-Budget 2007 basis. The revised 2006 figures and pre-Budget 2007 figures are derived from the Revenue model using the most recent base tax year (2003) for which data are available.

Tax year	Exempt		Marginal Band		Standard rate		Higher rate		All Cases
	Number	%	Number	%	Number	%	Number	%	
Pre-Budget 2006	686,074	33.3	18,657	0.9	608,772	29.5	748,872	36.3	2,062,375
Post Budget 2006	741,100	35.9	15,684	0.8	647,500	31.4	658,077	31.9	2,062,375
Revised Tax year 2006	776,100	35.9	18,826	0.9	681,886	31.6	683,693	31.7	2,160,500
Pre-Budget 2007	748,593	33.8	22,527	1.0	675,378	30.5	768,202	34.1	2,214,700

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15. To maintain the value of the bands and main credits[5] relative to forecast increases in wages (4.8% for 2007 over 2006) would cost about €545 million[6] in full year terms. To

[3] Post Budget 2006 estimate from the Revenue model using a base year 2002
[4] Post Budget 2006 estimate from the Revenue model using a base year 2002
[5] Personal Credit, Employee Credit and Home Carer Credit
[6] This cost assumes that the married one-earner (MIE) standard band would increase by 4.8% in addition to the single and married two-earner bands. However, the full year cost would be c.€85 million less at about €460 million, if no increase were to be made in the MIE band, thus ensuring further progress towards completing the process of widening the standard rate band and placing it on a per person basis.

maintain them in terms of forecast (CPI) inflation (3% for 2007 over 2006) would cost about €345 million[7] in a full year. These moves would reduce the percentage of income earners on the top rate (from 34.1% on a pre-Budget basis) to 32.2% and 33.2%, respectively. To index the main credits alone to forecast inflation would cost about €165 million in a full year. Raising the value of credits has no impact on the numbers of earners paying tax at the higher rate, although their tax bill is reduced.

Exempting those on the Minimum wage from tax

16. The statutory minimum wage is an average hourly rate of gross pay for an individual employee as defined under the National Minimum Wage Act, 2000. The minimum wage was introduced in April 2000. In that year, less than 64% of the minimum wage annualised was free of tax. Since then, the value of the minimum wage has been increased four times by almost 37% in all. The last increase took effect on 1 May 2005 when the wage was increased to €7.65 per hour. In annualised terms, the increase was from €14,200 to €15,515.

17. Following Budget 2006, 100.5% of the annualised figure for the minimum wage was exempt from income tax in the case of a single PAYE worker. In 2006, a single person in the PAYE sector earning €15,600 or less per year pays no income tax[8].

18. The following shows the level of income, for various categories of income earner, below which no income tax is payable.

Single person in the PAYE sector	€15,600
Married one-earner couple in the PAYE sector where there is no carer in the home	€23,750
Married one-earner couple in the PAYE sector where there is a carer in the home	€27,600
Married two-earner in the PAYE sector	€31,200

19. The draft new national partnership agreement "*Towards 2016"* contains a provision that ICTU and IBEC may jointly make a recommendation to Government by 1 Sept 2006 about a new minimum wage rate to apply from 1 January 2007. The draft agreement also provides that if agreement is not reached by 1 September either party may refer the matter to the Labour Court following consultation with the Minister for Enterprise, Trade and Employment. The cost implications of a 5% and 10% increase in the wage, respectively, are explored below.

20. The minimum wage may be relieved of taxation by increasing the Employee credit or the Personal credit or a combination of both. An increase of 5% in the Minimum Wage would increase the hourly rate to about €8.05 per hour. In order to exempt the annualised form of such a minimum wage from tax in the case of a single person, the value of either

[7]Roughly €50 million less at €295 million if there was no increase in the M1E band
[8] In addition, no PRSI is payable so that such a person retains 100% of his or her gross wage.

the Personal credit or Employee credit or a combination of both would have to be increased by at least €146 per annum. Using the Personal Credit alone would cost €295 million in a full year and using the Employee Credit alone would cost €200 million in a full year. To use a combination of the Personal and Employee credit, (an increase of €73 on each credit), would cost about €250 million in a full year.

21. An increase of 10% in the Minimum Wage would give rise to an hourly rate of about €8.45. In order to exempt the minimum wage annualised from tax in the case of a single person, the value of either the Personal credit or Employee credit or a combination of both would have to be increased by at least €308 per annum. Using the Personal Credit alone would cost €615 million in a full year and using the Employee Credit alone would cost €420 million in a full year. To use a combination of the Personal and Employee credit, (an increase of €154 in each credit) would cost about €520 million in a full year.

22. While policy relating to the PRSI system is a matter in the first instance for the Minister for Social and Family Affairs, it should be noted that in Budget 2006 the weekly threshold for PRSI was increased to ensure that there was no liability for a single person earning the minimum wage in 2006. The same issue may fall to be considered in the event of a new higher minimum wage being exempted from income tax in Budget 2007.

The level of the standard rate band

Average Industrial Wage and the Standard Rate Band

23. The latest estimate is that by end of 2006, the Average Industrial Wage will have a value of about €31,700. This figure is slightly lower than the estimate of €32,000 used in Budget 2006. Given the present level of the standard rate band set in Budget 2006, an employee the Average Industrial Wage currently pays no tax at the higher rate on their income.

24. If the average industrial wage increases by the projected increase in forecast wages for 2007 over 2006 (4.8%), it will amount to approximately €33,200 in 2007. Should the standard rate band remain static, this will mean that in 2007, such a person would pay tax at the higher rate on about 3.6% of their income. In 1999, about 17% of the Average Industrial Wage for a single person in that year was subject to higher rate tax. In comparison, by 2002 the situation had improved to an extent where a single person did not pay the higher rate of tax until his or her income reached 107% of the average industrial wage for that year. The latest position is that a single person will not pay tax at the higher rate until his or her income has reached about 101% of the Average Industrial Wage for 2006.

Percentage of income earners paying tax at the higher rate

25. It should be borne in mind that, in looking at the percentage of cases paying tax at the higher rate, it is more appropriate to talk in terms of "income earners" rather than "taxpayers" so that regard is had not only to those who pay tax in a given year but also to those who are exempt from taxation. The alternative approach which considers only those who pay tax in the year fails to take account of progress made in removing those on lower incomes from the tax net altogether. Also, under a tax credits system, the more

people who are exempted from tax, the higher the percentage of "taxpayers" in the top rate, even if there is no increase in numbers.

26. Considerable progress was made in the years 2000 to 2002 in reducing the percentage of income earners paying tax at the higher rate. By 2002 a position was reached where less than 27% of income earners paid tax at the higher rate. After Budget 2006, the position was that 31.9% of income earners were projected to pay higher rate tax this year. With rebasing of the Revenue Commissioners cost model, this has decreased slightly to 31.7%. As incomes are forecast to grow in 2007, the position will be that if there is no change to the value of the standard rate band, 34.7% of income earners are likely to pay the higher rate of tax next year.

Target of 80% of earners pay tax only at the standard rate

27. As indicated earlier in this paper, the Government programme contains a target to ensure that 80% of earners pay tax only at the standard rate. The commitment to widening the standard-rate band was originally made in the previous Government programme in 1997 in circumstances where, because of the system of tax allowances then in existence, it was possible to alter the numbers of earners paying tax at the higher rate by changes in either the value of allowances or the value of the bands or by changes in both. With the move to a system of tax credits and within the present two-rate band structure, such change now can only be effected through movement in the value of the standard band.

28. As previous paragraphs indicate, progress has been made in widening the standard band and the position has been reached where, in 2006, the person earning the Average Industrial Wage will not pay higher rate tax. Moreover, after tax income, adjusted for CPI inflation, for a person on the average industrial wage, is now 46% higher than it was in 1997. About half of this increase is due to lower taxes. In addition, the latest OECD data relating to 2005 show that for the single average production worker Ireland has the lowest tax wedge in the EU, and one of the very lowest in the OECD.

29. At the same time, having regard to the huge scale of the costs involved, estimated at €1.56 billion in a full year, it will not be feasible to meet the target in the Government Programme in the next Budget. A more achievable objective going forward which would be consistent with the over-arching commitment in the Government programme to pursue responsible fiscal policies, (and arguably most appropriate given the achievements in relation to the structure of the tax system) would be to widen the standard rate band further <u>so as to ensure that those earning the Average Industrial Wage remain outside the higher rate of tax.</u> Illustrative costings in this regard are as follows:

Measure	% of income earners remaining on the top rate	Full Year Cost (€m's)
(a) Increase Single Band to €33,200 (i.e.Continue to ensure that the Average Industrial Wage is exempt from higher rate tax in 2007)	33%	160[9]
(b) Increase the Single Band by €2,000 to €34,000	32%	255[10]
(c) Increase the Single Band to €36,100 (with no increase in the M1E Band)	30%	482 [11]
(d) Increase the Single Band to €35,570 (with M1E Band increased in line with CPI)	30%	500[12]

30. To complete the process of widening the standard rate band and placing it on a per person basis which began in Budget 2000 would cost an estimated €870 million in a full year. This would result in a position where over 26% of income earners remain on the top rate of tax. Further band widening would be needed to reach 20% which would bring the total cost to an estimate €1.56 billion.

The Health Levy

31. The Health Levy threshold was increased in Budget 2006 from €400 per week to €440 per week. This represented an increase of 10%. The equivalent annual threshold is now €22,880. Apart from exempt categories, such as those with entitlement to a medical card including those aged 70 and over, the Health levy is payable by all whose incomes exceed the weekly threshold. 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 in a reduction in his/her net take home pay. A €1 increase in annual pay can lead to a net reduction of €8.80 in net pay per week or €457 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. In 2006 the levy is expected to yield about €1.3 billion[13].

32. To address the issue of the 'step effect' mentioned above, the threshold could be converted into an allowance and the levy could be charged only on the portion of income at or over the allowance amount. This would remove the disincentive effect for those on lower pay to earn over the present threshold but would cost an estimated €580 million in a full year. To increase the value of the threshold relative to the expected increase in the

[9] Cost assumes the usual follow-on increases in the married two-earner and lone/widowed parent bands but without any increase in the married one-earner band. If the M1E band was increased commensurately, the full year cost would be about €65 million more at €225 million.
[10]Cost assumes the usual follow-on increases in the married two-earner and lone/widowed parent bands but without any increase in the married one-earner band. If the M1E band was increased commensurately, the full year cost would be about €110 million more at €365 million.
[11] Cost assumes the usual follow-on increases in the married two-earner and lone/widowed parent bands
[12] Cost assumes the usual follow-on increases in the married two-earner and lone/widowed parent bands
[13] Based on an estimate prepared by the Revenue tax costing model.

CPI for 2007 over 2006, i.e. by about €780 to €23,660, would cost an estimated €16 million in a full year. To increase its value relative to the expected growth in wages in 2007 over 2006, i.e. by about €1,040 to €23,920 would cost an estimated €21 million in a full year approximately. 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 €232 million in a full year. Restoration of the levy to those aged 70 or over would yield about €29 million in a full year while abolishing it for those aged 65 to 69 would cost the Exchequer about €31 million in a full year.

33. The Tax Strategy Group may wish to consider.

September 2006