Income Tax

1. Consideration of any changes to personal income tax in Budget 2008 will take place within the context of the overall structure of the 2008 Budget package and the personal income tax commitments in the new Programme for Government *"An Agreed Programme for Government"*. The provisions of the partnership agreement "*Towards 2016"* are also relevant insofar as they refer to taxation.

Programme for Government:
2. 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. 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."*

Issues relating to the PRSI system will be the subject of a separate paper for consideration by the Tax Strategy Group.

The Government Programme also includes the following commitment in relation to mortgage interest relief :

" Specifically we will…

- *Increase in Budget 2008 the ceiling on mortgage interest relief for first-time buyers and first-time buyers who bought a house in the past seven years, from €8,000 to €10,000 for single people and from €16,000 to €20,000 for couples or widowed persons.*
- *As income taxes are reduced, keep the rate of mortgage interest relief at 20% for all home owners. From 1 Jan 2008, mortgage interest relief will be worth up to €167 per month for a single person and €333 per month for a couple or widowed person. A couple or widowed person with a joint mortgage of up to €400,000 over 33 years at an interest rate of 5% or a single person with a mortgage of up to €200,000 will be able to claim interest relief on the full amount of interest on their loan. The maximum*

relief available to a single person will be €2,000, while for a couple or a widowed person it will be €4,000."

The Programme sets out guiding principles for economic and fiscal policy for the next five years 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."*

Partnership Agreement

3. The current Partnership Agreement *"Towards 2016"* refers to taxation 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 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………"

Reforms and developments in recent years

4. Over the last number of years significant reforms have been introduced to the personal income tax system.

Tax rates

The standard rate of income tax has been reduced by six percentage points and the higher rate of income tax has been reduced by seven percentage points since 1997. The standard rate of tax currently stands at 20% and the higher rate stands at 41%.

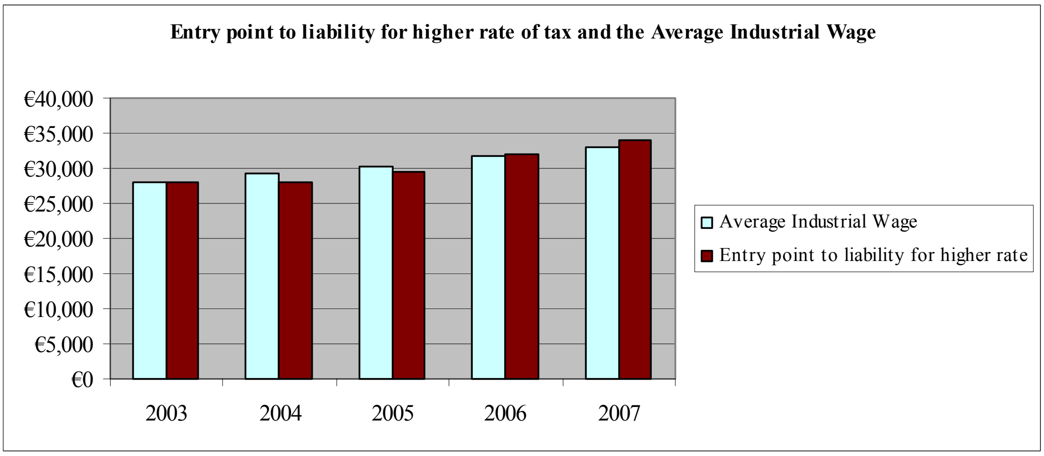
Widening the Standard Rate Band

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

Single	€34,000
Married One-Earner	€43,000
Married Two-Earner	€68,000 with transferability limited to €43,000.

After Budget 2007, 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 estimated percentage of earners who actually pay tax at the higher rate was just under 20%.

In addition, after Budget 2007, the position was that a single person on PAYE was not liable for the top rate of tax until his or her income reached €34,000 or 103% of the estimated average industrial wage for 2007[1]. The following chart indicates the position in this regard over the last five years.



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 and also reducing the number of income earners who actually pay tax at the higher rate.

Increases in the main personal allowances/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 €338 per week, or €17,600 per annum. This is equal to 100.3% 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 €581 per week, or €30,250 per annum; married two-earner PAYE couples pay no tax where income is at or less than €676 per week, or €35,200 per annum.

Budget 2007 income tax changes

5. The Budget 2007 income tax package maintained 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 €1,490 to €1,760. All employees benefited from this increase. The personal credit was increased by €130 to €1,760. These changes together ensured that the minimum wage remained outside the tax net in 2007, notwithstanding two increases in the minimum wage rate on 1 January 2007 to €8.30 per hour and on 1 July 2007 to €8.65 per hour. Progress was also made on widening the standard rate band. The single band was increased by €2,000 to €34,000. The married one-earner band was increased by €2,000 to €43,000 and the married two-earner band was increased to

[1] estimated at approximately €32,900 (using latest data from CSO)

€68,000 with transferability restricted to €43,000. The higher rate of tax was reduced by one percentage point to 41%.

6. The age exemption limits for those aged 65 and over were increased in Budget 2007 from €17,000 per annum for a single person and €34,000 per annum for a married couple, where one or both are aged 65 and over, to €19,000 per annum and €38,000 per annum respectively. Over the last six Budgets, the limits have increased by 76%.

7. The minor credits were also increased in Budget 2007. The incapacitated child credit was doubled in value to €3,000 per annum. The blind person's credit was increased to the same level as the personal tax credit, from €1,500 single and €3,000 per annum married to €1,760 and €3,520 per annum, respectively. The widowed person's credit was increased from €500 to €550 per annum. The widowed parent credit was also increased from €3,100 (Year 1), €2,600 (Year 2), €2,100 (Year 3), €1,600 (Year 4) and €1,100 (Year 5) to €3,750, €3,250, €2,750, €2,250, €1,750 per annum, respectively.

8. The Health levy threshold was also increased from €440 per week (€22,880 per annum) to €480 per week (€24,960 per annum). However, an extra 0.5% levy was introduced for earners in respect of their income in excess of €1,925 per week (€100,100 per annum).

9. The combined cost of the 2007 income tax measures was estimated at Budget time at €1,260 million in a full year.

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

	2006	**2007**	**Increase**	**Percentage Increase**
Tax Credits	**€**	**€**	**€**	**%**
Personal Credit	1,630	1,760	130	8.0
Employee (PAYE) Credit	1,490	1,760	270	18.1
Standard Rate Bands				
Single	32,000	34,000	2,000	6.3
Married one earner	41,000	43,000	2,000	4.9
Married two-earner	64,000	68,000	4,000	6.3

11. Budget 2007 removed an estimated 97,300[2] income earners on lower income from the tax net. It is estimated that after the Budget more than 845,900[3] income earners (38.2% 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 2007 is that a person earning the minimum wage is outside the tax net and a person earning the average industrial wage is not liable to tax at the higher rate. In international terms, the latest OECD data relating to the year 2006 indicate that for the single worker on the average earnings, Ireland has the lowest tax wedge[4] in the EU and one of the lowest in the OECD.

[2] Post Budget 2007 estimate from the Revenue model using a base year 2003
[3] Post Budget 2007 estimate from the Revenue model using a base year 2003
[4] The tax wedge is defined as income tax plus employee and employer PRSI as a proportion of gross wages plus employers PRSI

Distribution of Income Earners

13. The following table sets out the projected distribution of income earners taking account of the measures introduced in Budget 2007, as well as revised 2007 figures and a distribution on a pre-Budget 2008 basis. The revised 2007 figures and pre-Budget 2008 figures are derived from the Revenue model using the most recent base tax year (2004) for which data are available and taking account of forecast increases in employment and earnings in 2008.

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 2007	748,593	33.8	952, 436	43.0	513,671	23.2	2,214,700
Post Budget 2007	845,863	38.2	930,584	42.0	438,253	19.8	2,214,700
Revised Tax year 2007	867,960	38.0	939,440	41.1	478,000	20.9	2,285,400
Pre-Budget 2008	838,990	35.9	950,655	40.7	547,955	23.4	2,337,600

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14. XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX. XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

Cost of implementation of Government Programme and other items

15. The following paragraphs set out the costs associated with the various commitments in the Government Programme. The costings are based on the Revenue model. Costs can vary depending on the precise nature of the measure and whether they relate to individual items or a package of items where synergies can arise between credits, bands and rates. An income tax *Ready Reckoner* will be available shortly on the Finance website[5].

Indexation

Bands and Credits

16. To maintain the value of the bands and main credits[6] relative to forecast increases in wages (4.5% for 2008 over 2007[7]) would cost about €595 million[8] in full year terms. To maintain them in terms of forecast (CPI) inflation (2.7% for 2008 over 2007) would cost about €370 million in a full year. These moves would reduce the percentage of income earners whose liability for tax at the higher rate is not offset by their credits from 23.4% on a pre-Budget basis to 21.4% and 22.1%, respectively.

[5] www.finance.gov.ie

[6] Personal Credit, Employee Credit and Home Carer Credit

[7] European Commission Spring 2007 forecast

[8] This cost assumes that the married one-earner (M1E) standard band would increase by 4.5% in addition to the single and married two-earner bands.

Keep low income earners out of the standard rate band

17. Currently, low earners in the PAYE sector who are under 65 years of age are exempt from income tax on income up to €17,600 per annum. The Government Programme contains a commitment "to use tax credits and bands to keep low income earners out of the standard rate band." It is reasonable to interpret this as a commitment to ensure that the value of the main personal credits are sufficient to ensure that those on the minimum wage continue to be exempt from tax.

18. Any increases in the credits will need to have regard to developments in relation to the statutory minimum wage. This 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 six times by 55% in all. The last increase took effect on 1 July 2007 when the minimum wage was increased to €8.65 per hour. In annualised terms, this equates to €17,543 per annum. The two most recent increases in the wage in January and July 2007 were implemented arising from a process provided for in "Towards 2016". The provisions of that agreement in relation to the minimum wage have now been fully implemented.

19. It was possible in Budget 2007 to ensure that the increases in the minimum wage which were subsequently implemented in 2007 were taken into account in setting the value of the main personal credits for 2007. Following Budget 2007, 100.3% of the annualised figure for the minimum wage is exempt from income tax in the case of a single PAYE worker. In 2007, a single person in the PAYE sector earning €17,600 or less per year pays no income tax[9].

20. 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	€17,600
Married one-earner couple in the PAYE sector where there is no carer in the home	€26,400
Married one-earner couple in the PAYE sector where there is a carer in the home	€30,250
Married two-earner in the PAYE sector	€35,200

21. Increases in the value of the main credits in line with forecast wage increases would cost approximately €280 million in a full year.

Keep Average earners out of the higher band.
Average Industrial Wage and the entry point to the higher band.

22. As indicated earlier in this paper, the Government programme contains a commitment to use tax credits and bands to keep average earners out of the higher band. It is reasonable to interpret this as a commitment to maintain the current position where average earners will not face a liability to tax at the higher rate and that the standard rate band will be maintained at a level higher than the average industrial wage. The latest estimate is that by end of 2007, the Average Industrial Wage will have a value of about €32,900. This figure is on par with the estimate of €33,000 used in Budget 2007. Given

[9] In addition, no PRSI is payable so that such a person retains 100% of his or her gross wage.

the present level of the standard rate band set in Budget 2007, an employee earning the Average Industrial Wage is currently placed well outside liability to tax at the higher rate.

23. If the average industrial wage increases by the projected increase in forecast wages for 2008 over 2007 (4.5%), it will amount to approximately €34,500 in 2008. Should the standard rate band remain unchanged, this would mean that in 2008, such a person would face a liability to tax at the higher rate on about 1% of their income.

24. Increases in the bands in line with forecast increases in wages would give the following structure:

Single:	€35,500
Married one-earner:	€44,900
Married two-earner:	€71,000 (with transferability limited to €44,900).

The cost of such an increase in the bands would be approximately €310 million in a full year.

Percentage of income earners paying tax at the higher rate

25. It should be borne in mind when looking at the percentage of earners paying tax at the higher rate, that it is more appropriate to talk in terms of "number paying at the higher rate" rather than "numbers liable to tax at the higher rate" as the latter term fails to take account of the group of earners whose liability to tax at the higher rate is fully offset by their tax credits.

26. When one looks at the percentage of earners who are actually paying tax at the higher rate, i.e. their credits are insufficient to fully offset a liability to higher rate tax, the position is that, after Budget 2007, 19.8% of income earners actually pay tax at the higher rate. With rebasing of the Revenue Commissioners' cost model, this has increased slightly to 20.9%. As incomes are forecast to grow in 2008, the position will be that if there is no change to the value of the standard rate band, the tax credits or the higher rate, 23.4% of income earners are likely to actually pay tax at the higher rate of tax next year.

27. In order to ensure that no more than 20% of income earners are actually paying tax at the higher rate in 2008 (the target in the previous Programme for Government), and assuming no change to the value of the credits or higher rate of tax, the standard rate band would have to increase by €3,500 as follows:

Single:	€37,500
Married one earner:	€46,500
Married two earner:	€75,000 (with transferability limited to €46,500)

The full year cost for such an increase would be approximately €635 million.

Reduce the standard rate and the higher rate.

28. As indicated above, the Government Programme contains a commitment to reduce the standard rate of tax to 18% and the higher rate of tax to 40%, over the lifetime of the Government if economic resources allow. It should be borne in mind that any reduction in the standard rate will have a direct effect on the real value of the credits and will therefore increase the entry point to taxation for low income earners above the current level.

29. A reduction in the standard rate of 1 percentage point would cost approximately €565 million in a full year. This reduction would increase the real value of the Personal and Employee tax credits by 5% thus increasing the entry point to the tax net to €18,526, and exempt an additional 44,000 income earners from tax.

30. A reduction in the standard rate by 2 percentage points would cost approximately €1,120 million in a full year. This reduction would increase the real value of the Personal and Employee tax credits by 11% thus increasing the entry point to the tax net to €19,556, and exempt an additional 92,000 income earners from tax.

31. A reduction in the higher rate by 1 percentage point from 41% to 40% would cost approximately €280 million in a full year. This reduction would ensure that an additional 6,000 taxpayers who have a liability to tax at the higher rate would pay tax only at the standard rate.

Mortgage Interest Relief

32. The Government Programme contains a specific commitment in relation to Mortgage Interest Relief as outlined earlier in this paper. An increase in the ceiling on MIR, for first-time buyers and those who have bought a house in the last seven years, from €8,000 to €10,000 for a single person and from €16,000 to €20,000 for a married couple or widowed would cost in the region of €10 million on a full year basis assuming an interest rate of 5%.

33. Under the current limits, a couple or widowed person with a joint mortgage of €321,500 over 33 years at an interest rate of 5%, or a single person with a mortgage of up to €160,750 with the same terms, will be able to claim interest relief on the full amount of interest on their loan.

34. However, the proposed increases would ensure that a couple or widowed person with a joint mortgage of €400,000 over 33 years at an interest rate of 5%, or a single person with a mortgage of up to €200,000 with the same terms, would be able to claim interest relief on the full amount of interest on their loan.

The Health Levy

35. There are no commitments in the Government Programme in relation to the health contribution levy. The health levy threshold was increased in Budget 2007 from €440 per week to €480 per week. This represented an increase of 9%. The equivalent annual threshold is now €24,960. 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 €9.60 in net pay per week or approximately €500 per annum. As indicated earlier in this paper, 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 the €1,925 per week (or €100,100 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 2007 the health levy is expected to yield about €1.6 billion[10].

36. To address the issue of the 'step effect' mentioned above by turning the lower threshold into an allowance would cost an estimated €705 million in a full year. To increase the value of the threshold relative to the expected increase in the CPI for 2008 over 2007, i.e. by about €670 to €25,630 would cost an estimated €15 million in a full year. To increase its value relative to the expected growth in wages in 2008 over 2007, i.e. by about €1,120 to €26,080 would cost an estimated €25 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 €265 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.

37. As outlined above, Budget 2007 introduced an increased health levy of 2.5% on income exceeding €1,925 per week or €100,100 per annum. A 0.5% increases in this higher levy from 2.5% to 3% would yield over €55 million in a full year.

38. It should be noted that in the previous two Budgets the weekly threshold for PRSI was increased in line with increases in the value of the main personal credits to ensure that there was no liability to tax or PRSI for a single person earning the minimum wage in 2007. The entry point to PRSI may fall to be considered having regard to the nature of the income tax package.

39. The Tax Strategy Group may wish to consider.

September 2007

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