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# POVERTY TODAY

## Supplement

# Analysis of Budget 2005



**Combat Poverty  
Agency** *working for a  
poverty-free Ireland*

## Introduction

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Combat Poverty is the state body with responsibility for developing and promoting evidenced-based proposals and measures to combat poverty in Ireland. The annual budget is a critical component of government policy to tackle poverty, as set out in the National Anti-Poverty Strategy (NAPS). In advance of Budget 2005, Combat Poverty made a detailed submission containing a range of budgetary proposals to tackle poverty. This follow-up analysis examines the measures introduced in the Budget and assesses the impact of the tax/welfare changes on income distribution and poverty.

To aid this assessment, the analysis uses the SWITCH tax/welfare model to simulate the effect of the welfare and tax changes for a national

<sup>1</sup> Tax/welfare models provide a comprehensive assessment of the effects of tax/welfare changes, taking into account the wide diversity of individual and family circumstances relevant to tax liabilities and welfare entitlements. The SWITCH tax/welfare model has been developed by the Economic and Social Research Institute based on a nationally representative sample of households. For further information on the model and its use as a tool for analysing tax/welfare policy, see Callan, T. et al., *Reforming tax and welfare*, Dublin: Economic and Social Research Institute, 2001.

representative sample of households.<sup>1</sup> This is a qualitative advance on the standard budget analysis, which either presents the typical gains/losses for different welfare or tax categories without regard to individual circumstances or focuses on the combined effects for a few hypothetical families

Assessing the poverty impact of budgetary policy is an explicit requirement under the National Anti-Poverty Strategy. The Department of Finance produces its assessment of the poverty impact of the budget's tax measures as an accompaniment to the official budget documentation. This analysis complements this perspective by looking at the combined effects of tax and welfare changes and by using a different methodology.

## Overview of Budget 2005

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Budget 2005 is the third budget introduced by the Government. Unlike the previous two budgets, the fiscal environment for Budget 2005 was much improved, driven by a significant growth in tax revenues, while expenditure was slightly below forecast. The improvement in the public finances enabled a tax/welfare package of €1,570 million in Budget 2005, a significant advance on Budgets 2003 and 2004 (an increase of 119 per cent and 71 per cent, respectively). Of this, €874 million was allocated to welfare measures, up by 39 per cent on 2004 and 65 per cent on 2003. The tax reductions

were valued at €694 million, 1.5 times the 2004 amount and almost four times the 2003 allocation.

Budget 2005 also outlined additional social expenditure, particularly in care facilities for people with disabilities. In addition, the earlier Book of Estimates (which details the main spending components of the Budget) contained a number of important social inclusion measures, notably higher eligibility thresholds for medical cards, resulting in an additional 30,000 full medical cards and 200,000 doctor-only medical cards in 2005.

## Welfare changes

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The increases in personal rates of payment in Budget 2005 were between €12 and €14 per week, depending on welfare category. Compared to other living standard indicators, the welfare improvements are up to four times the forecast rate of inflation (2.5 per cent) and up to twice the forecast wage growth of 4.5 per cent.

The changes are summarised in Table 1 and differentiate between three levels of welfare payment relating to age. The lowest payments, for a diverse range of recipients aged under 66, got a flat €14 increase per week, the equivalent of between 9.4 per cent and 10.4 per cent (payments for unemployed, widows/widowers, carers, invalids and lone parents). The new payments range from €148.80 to €163.70 per week. Middle rates of payment for recipients aged between 66 and 79 years (pensioners) got an increase of €12 per week,

equivalent to between 7.2 per cent and 7.8 per cent. These payments now range between €166 and €179.30 per week. The highest payment rates, for pensioners over 80 years, were also increased by €12 per week, equivalent to between 6.9 per cent and 7.3 per cent. The new payments are between €173.40 and €185.70 per week.

The welfare increases are significantly higher than those of Budgets 2003 and 2004, when payments rose between €6 and €10 per week. More significantly, the lowest payment rates received the highest improvements, a significant reversal of policy in Budget 2003 and, to a lesser extent, Budget 2004. The increases for the lowest payment were €6, €10 and €14 in Budgets 2003, 2004 and 2005, as compared to €10, €10 and €12 for the highest rates. As a consequence, the percentage gain for the lowest payment categories (those aged less than

**Table 1: Welfare changes in Budget 2005**

Category	Payment range	Increase (%)	New payment range
Under 66 years	€134.80 – €149.70	€14 (9.4% – 10.4%)	€148.80 – €163.70
66 to 79 years	€154 – €167.30	€12 (7.2% – 7.8%)	€166 – €179.30
80 years +	€160.40 – €173.70	€12 (6.9% – 7.3%)	€173.40 – €185.70

66 years) was between a third and a half more than for pensioners in Budget 2005. This has also led to a reduction in the payment range. However, there remains a wide differential between the bottom and the top of the range: €148.80 to €185.70, a difference of €36.90 or 25 per cent.

We can also consider the welfare changes in the light of the NAPS policy target of a minimum welfare payment of €150 per week (2002 values). The lowest welfare rate is now €148.80, as compared to the inflation-indexed target of €162.63 for 2005, leaving a shortfall of €13.83 (Table 2). Budget 2005 has made significant inroads into meeting the target, reducing the shortfall by €10 as compared to Budget 2004. This is by far the biggest impact of the three budgets in this period and reflects a combination of a higher level of increase and a lower rate of inflation. Table 2 also sets out the increases needed in the remaining two budgets to 2007, if the inflation-adjusted target is to be met. Requiring a €10.80 per annum increase, this suggests that the target figure is now within reach, if the exchequer finances remain in a healthy state. This calculation makes no adjustment for inflation in 2002, though the target figure was announced in February 2002, and the inflation rate for that year was a comparatively high 4.6 per cent. If the baseline figure is adjusted to take

2002 inflation into account, then the basic increase required in Budgets 2006 and 2007 rises to €14.70 each year.

An alternative adjustment of the €150 target is to link it with changes in gross average industrial earnings.<sup>2</sup> For 2007, this is forecast to be €185.80. To meet this target would require a minimum welfare increase of €18.50 in each of the next two budgets.

The general increase for qualified adult dependants was €7.90 and €9.30. These amounts were in line with existing equivalence scales, the majority of which are set at 66 per cent of the personal rate. The Government set a policy target for the adult equivalent scale of 70 per cent in Budget 2000. However, no progress was achieved in this regard in Budget 2005.

Other welfare measures included more generous income disregards (Carer's Allowance, half-rate child dependant allowance and Supplementary Welfare Allowance), abolition of the benefit and privilege rule for Unemployment Assistance and enhancements in the diet supplement and rent and mortgage supplements. The total cost of the welfare package was €738 million, with €679 million for the increases in personal and qualified adult welfare rates.

**Table 2: Trends in lowest welfare rate in relation to inflation-adjusted NAPS minimum welfare target<sup>3</sup>**

Year	Budget increase	Lowest rate	Target amount	Gap
2002		€118.80	€150	€31.20
2003	€6	€124.80	€155.25	€30.45
2004	€10	€134.80	€158.67	€23.87
2005	€14	€148.80	€162.63	€13.83
2006	€10.80	€159.60	€166.54	€6.94
2007	€10.80	€170.40	€170.37	

<sup>2</sup> The Conference of Religious in Ireland interprets the €150 target as the equivalent of 30% of gross average industrial earnings in 2002 (CORI Justice Commission, *Budget 2005 Analysis and Critique*).

<sup>3</sup> The inflation rates for the respective years are: 2003 – 3.5%; 2004 – 2.2%; 2005 – 2.5%; 2006 – 2.4%; 2007 – 2.3%. The 2005, 2006 and 2007 figures are Dept of Finance estimates.

## Child income support

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The child benefit increase in Budget 2005 was €10 per month for the first and second child and €12 per month for the third and additional child. This brings child benefit to €141.60 and €177.30 per month, respectively (weekly equivalent of €32.55 and €40.76). The rate of increase is between 7.2 – 7.6, which is three times the forecast rate of inflation and one and half times wage growth.

This increase is still short of the child benefit target of €149.20 per month, originally to be met by 2003 and subsequently deferred until 2005. It is now intended that the target will be met in 2006. The child benefit target was set in the context of a coherent and inclusive policy response to the direct and indirect costs of children. The repeated deferral of the child benefit target has damaged the credibility of this approach and encouraged a variety of sectional demands, for example, childcare tax reliefs. It has also undermined the development of a comprehensive first tier of child income support, upon which more targeted measures could be developed on child poverty, lone parents, etc.

A further consequence of this continued deferral of the target rate is that its value has been diminished in real terms. Hence, the inflation-adjusted target will be €160 in 2006, almost €11 more than the proposed figure. This means that the deferred target rate in 2006 will be worth 7 per cent less compared to 2003. Given that 2003 was the stated date for the child benefit target and following the updating principle for the €150 welfare target, it would seem

logical that the target amount now set for implementation in 2006 is inflation-adjusted to reflect its original valuation.

Budget 2005 continued the longstanding policy of not increasing child dependent allowances, leading to a further devaluation in the value of these payments by 2.5 per cent (inflation) or 4.5 per cent (wage growth). When child dependent allowances are combined with the higher child benefit (the weekly equivalent of €49.35 at the lowest rates), the overall increase in the low-income child support package is 4.9 per cent, as compared to 7.2 – 7.6 per cent for non-welfare families. In addition, as this increase is significantly below the increase in adult welfare rates, the overall gains for families on welfare are diluted. It also means that the relative value of the child support package vis-à-vis the personal welfare rate has declined to between 32 and 33 per cent (from 33.5 to 35 per cent). This is marginally below the adequacy range set out in the National Anti-Poverty Strategy of 33 to 35 per cent. If the current policy of substantial welfare increases but far lower child income improvements continues, the resultant decline in the equivalence scale will breach the child adequacy commitment.

The third child income support instrument, which targets in-work families – the Family Income Supplement – increased by €39 per week or 9.6 per cent. Finally, no specific measures to assist with childcare costs were introduced in the budget.

## Tax changes

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The main components of the tax package in Budget 2005 were:

- Increase in employee tax credit by €230 to €1,270 (increase of 22 per cent)
- Increase in personal tax credit by €60 to €1,560 for a single person and €120 to €3,160 for a married couple (increase of 4 per cent)
- Widen tax band by €1,400 (increase of 5 per cent)
- Increase health levy threshold by €44 per week to €400 (increase of 12 per cent).

The total cost of these measures was €682 million, with the main items being €400 million for the tax credit changes and €233 million for the tax bands.

A key driver in the tax changes was to fully exempt people earning the minimum wage from the tax

system. As a result, one-third of all earners will be tax exempt. Tax credits are the fairest way to reduce the tax burden, as those on low incomes benefit most in proportionate terms. However, it is still an expensive reform because all taxpayers benefit and the bulk of the cost accrues to higher earners. By contrast, widening the tax band is a regressive measure, as it only benefits higher earners. However, as this was the first time in three budgets that the tax band was widened, it does not reverse the incremental drift of taxpayers into the higher tax band.

The budget also introduced a number of targeted income tax reliefs, reduced stamp duty for first-time buyers and made some minor reductions in VAT, excise duty and farmer taxation. The cost of these changes is in the region of €100 million per annum.

## Distributive impact of Budget 2005

The total size of the budgetary package available for distribution in Budget 2005, as compared to a wage-indexed neutral budget, was €600 million.<sup>4</sup> This resulted in an average gain from Budget 2005 of 1 per cent or a weekly cash amount of €5.42 per adult equivalent. While all income categories gain from Budget 2005, the average increase masks a wide variation in benefit across the income schedule.

Figure 1 presents the percentage gains as a result of Budget 2005 for the population, divided into income deciles of equal size ranging from the poorest to the richest.<sup>5</sup> Higher percentage gains go to the bottom 40 per cent of the income range (weekly equivalent income < €288 per week), while the top 40 per cent (weekly equivalent income > €393) get less than the average. Among the higher beneficiaries, there is a sharp tapering in terms of percentage gain, from a high of 4.9 per cent for the lowest decile to 1.4 per cent for the fourth decile. At the higher end, the variation is much less, ranging from 0.7 per cent to 0.3 per cent. This outcome reflects the targeting of higher welfare increases at the lowest income categories.

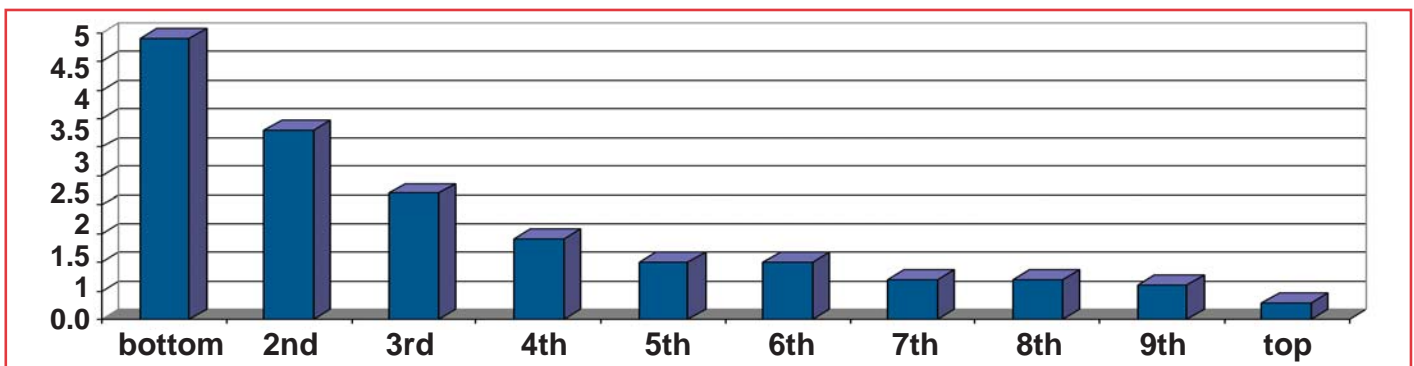
In contrast to the sharply tapered percentage gain for low-income groups, the weekly cash gain for all income groups under Budget 2005 is more uniform. The bottom 40 per cent of households benefit by €5.50 to €6.50 per week (adult equivalent), while the gain at the top is only slightly smaller, at €4 – €5 per week. This pattern arises because of the polarised structure of the tax system, where 20 per cent of taxpayers pay over 70 per cent of all income tax. Thus, small percentage reductions in the overall tax burden can mean significant cash gains for higher earners.

Another way of looking at the distributive outcome is to examine how the total amount of resources over wage-indexation in Budget 2005 (€600 million) was shared between income groups. This picture reveals that available resources were distributed evenly in relation to income decile. Thus, 45 per cent of the additional resources went to the bottom 40 per cent of the households, while the richest 40 per cent received 35 per cent. This reflects the significant tax package in Budget 2005, which was ahead of indexation by €232 million, as compared to the additional welfare allocation of €364 million. In addition, a significant proportion of the additional welfare package (€53 million or 14 per cent) relates to child benefit, which benefits families across all income groups.

We can also look at the budgetary gains for different types of families in terms of income source and composition. In general, non-working families do best. The single unemployed, non-earning lone parents and unemployed couples benefit by between 3 and 5 per cent. In some cases, these percentage gains reflect substantial amounts, for example, €13 for unemployed couples and €10 for non-earning lone parents. By contrast, earning families of different composition generally gain less than 1 per cent. An intermediate category is retired households, who gain between 1.5 and 2 per cent. This outcome is in keeping with the pro-welfare emphasis in the budget. Meanwhile, households with children – whatever their income source – fare slightly worse than their non-child counterparts. This reflects the already highlighted absence of a child focus to the tax/welfare measures introduced in Budget 2005.

**Figure 1: Distributive impact of Budget 2005**

(% change by equalised disposable income per decile)



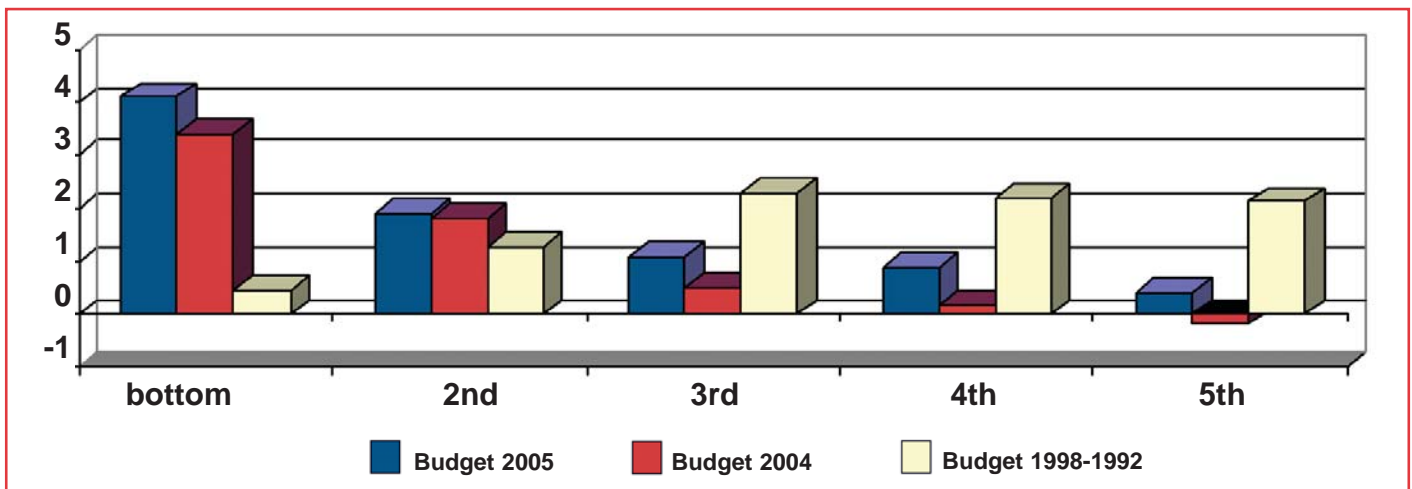
<sup>4</sup> In considering the distributive impact of Budget 2005, the first task is to establish an appropriate comparator. The standard approach is to examine budget changes against a backdrop of no policy change, that is, welfare and tax rates are frozen in nominal terms based on the previous year's budget. This is misleading in that it assumes a starting point of losses in real income as a result of inflation, while taxes rise as wages increase. An alternative approach is to measure change using a 'distributionally neutral' budget, whereby all sectors of the population share equally in the benefits of economic growth. One such benchmark is to index tax and welfare rates in line with wage growth, which gives a similar increase in income for all population categories in line with growth in national income. Such a budget is also neutral in macro terms as it maintains the overall share of taxes and welfare expenditure as a percentage of GNP. For our analysis of the distributive impact of Budget 2005 against a neutral budget, a forecast wage growth of 4.5 per cent is used.

<sup>5</sup> The range of disposable income per adult equivalent for the deciles is: < €141; €141 – €176; €176 – €216; €216 – €288; €288 – €339; €339 – €393; €393 – €458; €458 – €522; €522 – €653; > €653.

## Budget 2005 in context

**Figure 2: Distributive impact of Budget 2005 compared to Budget 2004 and Budgets 1998 – 2002 (annualised)**

(% change by equalised disposable income per quintile)



The distributive impact of Budget 2005 can be compared to that of Budget 2004 and also with the earlier 'bonanza' budgets of 1998 – 2002 under the previous Fianna Fáil/Progressive Democrats government.<sup>6</sup> This is presented in Figure 2 using five equally sized income quintiles, for ease of comparison. This comparative perspective enables the tax/welfare choices underlying Budget 2005 to be put in a medium and longer-term policy context. Budget 2005 was almost three times as generous as Budget 2004, resulting in average gains of 1 per cent and 0.4 per cent, respectively. Both budgets favoured lower income groups in roughly proportional terms (3 – 4 per cent for the bottom 20 per cent and 2 per cent for the next 20 per cent). The main difference is for higher income groups: Budget 2004 resulted in little or no change, while Budget 2005 conveyed a modest percentage gain, with the cash gain similar to that of lower income groups. This difference is best illustrated by comparing the allocation of additional budget

<sup>6</sup> Budget 2003 is omitted from this analysis as its redistributive effect was minimal.

resources. In Budget 2004, almost 90 per cent was allocated to low-income households, with the better-off being net contributors of €40 million to this pool. Budget 2005, by contrast, gave roughly similar shares to low and high-income groups. Though the redistributive focus of Budget 2004 was retained in Budget 2005, the bigger package of resources greatly enhanced the impact on better-off groups.

The largest tax/welfare budgetary packages were in the period 1998 – 2002, which delivered average annual gains of up to 2 per cent (twice that of Budget 2005). However, these gains were concentrated among middle and higher income groups, with those on the lowest incomes recording modest increases. Within that period, the closest comparison is Budget 2002, when the average gain was also 1 per cent. Then, as with Budget 2005, the main beneficiaries were the poorest 40 per cent, who gained 4 per cent. However, most budgets in this period had primarily an income tax focus.

## Poverty impact of Budget 2004

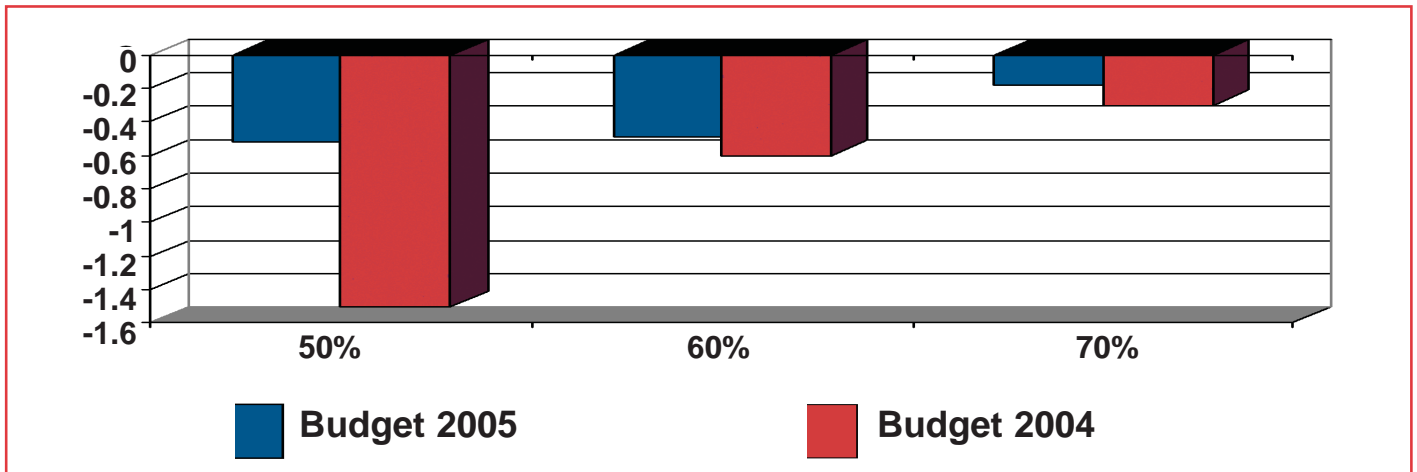
We turn now to consider the budgetary impact on relative income poverty, again using a wage-indexed benchmark. For this analysis, a measure of the proportion of people below various relative income thresholds is used, in this case 50, 60 and 70 per cent of median income.<sup>7</sup> Figure 3 illustrates the effect of Budget 2005 on these measures of income poverty, as compared to Budget 2004. Budget 2005 has a modest impact on reducing income poverty, producing a fall of half a percentage point at both the 50 per cent and 60 per cent lines, though only 0.2

per cent at the 70 per cent line. These reductions are somewhat less than achieved in 2004, though having a greater tax/welfare package. Budget 2004 achieved a fall of 1.5 per cent at the 50 per cent line, while the 60 and 70 per cent lines fell considerably less (0.3 – 0.6 per cent). These comparative data reflect the fact that Budget 2005, though having higher welfare increases for those on low incomes, also benefited all income groups to a significant extent, thereby raising the various income poverty thresholds.

<sup>7</sup> The post-budget adult equivalent is €184, €220 and €257, respectively.

**Figure 3: Reduction in relative income poverty after Budgets 2004 and 2005**

(50%, 60% and 70% of median income)



This modest reduction in relative income poverty must be set in the context of the continuing rise in relative poverty in Ireland and its high incidence in comparative EU terms. This weak comparative performance of Ireland is primarily attributable to the

social welfare system, in particular the low levels of payment relative to average earnings. To reduce poverty rates in line with best European practice, it is estimated that an investment of €2,400 million in higher welfare payments would be required.<sup>8</sup>

<sup>8</sup> Callan, T. et al., *Why is relative income poverty so high in Ireland?* Dublin: ESRI, 2004.

## Broader issues influencing poverty policy

This analysis primarily focuses on tax/welfare changes. There are other policies that impact on income distribution and poverty which are not measured in this analysis. These include higher social expenditure through more medical cards and improved disability services in Budget 2005. Equally, higher user charges and the clawback of welfare payment through means-testing for differential rents, etc., are not factored in. The impact on low-income households of higher waste collection charges, especially in the majority of counties without a waiver system, are of particular concern in this regard. As waste collection is increasingly taken over by private operators, the establishment of a national waiver system that applies to users of both public and private services becomes more acute.

The forecast low inflation rate of 2.5 per cent will maximise the effect of the high welfare increases. However, the Irish inflation rate is still among the highest in the EU, which indicates the scope for further reduction. Furthermore, there is some evidence to suggest that the eroding effect on the living standards of urban low-income households is under-estimated by the general inflation measure.<sup>9</sup>

Other aspects of the tax system warrant further analysis, in particular an examination of the distributive effect of indirect taxes. All income groups

pay indirect taxes and they account for almost half of the tax take (50 per cent more than income tax returns). Furthermore, their effect is far more regressive than other forms of taxation, accounting for one-fifth of the incomes of the poorest decile, compared to 10 per cent of the richest.<sup>10</sup> In this context, the avoidance of higher VAT rates in Budget 2005 is a positive outcome.

A key fiscal policy issue to emerge from Budget 2005 is the effect of discretionary tax reliefs relating to expenditures on health, housing and pensions and investment in property and other economic activities. The total cost of discretionary tax expenditures is over €7 billion, with €200 million pertaining to investment reliefs.

The continued economic benefits of these expenditures are questionable, a problem compounded by the frequently unpredictable level of costs involved. In addition, these expenditures introduce inequities into the tax system in that they are of more benefit to higher earners. As a result, some top earners have reduced their effective tax rates to below 20 per cent. In his budget statement, the Minister for Finance signalled his intention to undertake a review of these reliefs, which is to be welcomed.

<sup>9</sup> Murphy, E. and Garvey, E., *A consumer price index for low-income households (1989-2001)*, Combat Poverty Working Paper 04/03, Dublin: Combat Poverty Agency, 2004.

<sup>10</sup> A Combat Poverty study on this topic will be published in 2005.

Another issue is the impact of the Special Savings Incentive Scheme (SSIA). This is now estimated to cost the exchequer between €2.5 and €3 billion. To put this in context, this is up to five times the additional tax/welfare package over wage indexation in Budget 2005 or up to eight times the wage-adjusted value of the welfare package. It is critical that the distributive effect of this government windfall is fully evaluated and subsequently factored into future tax/welfare policies.

It is salutary to put the cost of this scheme into the context of the cost of the proposals for reducing the high rate of relative income poverty in Ireland in line with the EU norm, which was €2,400 million. The cost of the scheme is equivalent to the cost of reducing the high rate of relative income poverty in Ireland to the EU norm.

## Conclusion

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Budget policy has a key role to play in the implementation of the National Anti-Poverty Strategy, directly, through the achievement of minimum welfare targets, and indirectly, by reducing relative income poverty. This analysis shows that Budget 2005 has made significant strides in meeting the €150 per week welfare target with its headline €14 increase in personal welfare rates. The impact is far less, though, in terms of child income support. The significant tax changes, though focused at low earners, will benefit all taxpayers.

In overall terms, Budget 2005 retains the progressive outcome of recent budgets, delivering gains of up to four times the average for low-income groups, though higher earners gained equivalent amounts in

cash terms. Budget 2005 had a marginal effect on relative income poverty, far less than in 2004. The significant allocation to tax improvements, which predicated on removing low earners from the tax net, delivered considerable resources to the richest 40 per cent of the population. The absence of a specific child or family focus to the measures meant that households with children did relatively less well. A change of priorities, whereby more resources are spent on child benefit over tax reductions, would enhance the gains for all families, while benefiting low-income families in particular. Going forward, the key policy challenge will be to increase the child benefit package, preferably to the detriment of tax reductions.

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