

*action on*

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# POVERTY TODAY

## Supplement

# Analysis of Budget 2004

**"Budget 2004 enhances the progressive focus of recent budgets, delivering gains of up to 4 per cent for low-income groups against a wage-index budget, while higher earners record a small loss. Budget 2004 also has a positive effect on relative income poverty, thereby contributing to government policy targets."**



**Combat Poverty**  
*working for the prevention  
and elimination of poverty* Agency

# Introduction

Combat Poverty has a statutory duty to advise government on all aspects of economic and social policy pertaining to poverty. The annual budget is a key vehicle for government policy, with a major potential to reduce the level of poverty in accordance with the National Anti-Poverty Strategy. In particular, the budget is central to achieving a key target of the strategy: a minimum welfare payment of €150 per week (2002 values) by 2007.

This report analyses the impact of Budget 2004 on low-income households at two levels: the overall distributive impact of tax/welfare changes and the effect on rates of relative income poverty. The analysis also takes a longer-term perspective in order to identify underlying trends over the past seven years of government tax/welfare policy. Other fiscal factors that influence the redistributive potential of budget policy are considered in a concluding section.

Assessing the equity and poverty impacts of government policy, including budgetary policy, is an

explicit requirement of the National Anti-Poverty Strategy. Significantly, the Department of Finance publishes an assessment of the poverty impact of the budget's tax measures. It is hoped that this analysis will contribute to evolving methodologies for assessing the poverty impact of public policy. In undertaking this analysis, Combat Poverty draws on its original submission on Budget 2004, the Department of Finance's assessment of the poverty impact of Budget 2004 and analyses provided by the Economic and Social Research Institute using its tax/welfare micro-simulation model, SWITCH<sup>1</sup>.

<sup>1</sup> SWITCH provides a comprehensive assessment of tax/welfare changes, taking into account the wide diversity of individual and family circumstances relevant to tax liabilities and welfare entitlements. This is a qualitative advance on the standard budget analysis offered by the media, 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. For further information on the model and its use as a tool for analysing tax/welfare policy, see T. Callan et al., *Reforming Tax and Welfare*, Dublin: ESRI, 2001. The interpretation of the analyses in this paper is the sole responsibility of Combat Poverty.

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## Measuring budgetary impact

We begin by summarising the main tax/welfare components of Budget 2004. The total tax/welfare allocation in the budget was €917 million, a significant advance on Budget 2003 when the total allocation was €716 million. The amount spent on welfare improvements was €630 million as compared to €530 million the previous year. The figure for tax reductions was €287 million, up from €186 million in 2003. The share out between welfare improvements and tax reductions was 68 per cent and 32 per cent respectively. In Budget 2003 the respective shares were 74 per cent and 26 per cent.

The main welfare change was a flat €10 per week increase in personal rates, with increases of between €6.60 and €7.70 in qualified adult allowances. Child benefit increased by €6 per month, while child dependant allowances were unchanged. The income thresholds for Family Income Supplement increased by €28. The key tax change was the increase of €240 per annum in the employee credit.

In considering the distributive and poverty impacts of Budget 2004, the first task is to establish an appropriate comparator. The standard approach is to

examine budget changes against a backdrop of no policy change, i.e. 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 and poverty impacts of Budget 2004 against a neutral budget, a forecast wage growth of 3.5 per cent is used. This compares with a forecast inflation rate of 2.5 per cent.<sup>2</sup>

<sup>2</sup> T. Callan et al., 'Budget 2004: Impact on Income Distribution and Relative Income Poverty', in D. McCoy et al. (eds.), *Quarterly Economic Commentary*, Dublin: ESRI, 2004.

# Distributive impact of Budget 2004

Figure 1 presents the gains and losses as a result of Budget 2004 by dividing the population into ten income groups of equal size ranging from the poorest to the richest.

The average increase of 0.4 per cent masks a wide variation in benefit. The four lowest income deciles (adult equivalent income < €247) gain significantly above the norm, from nearly 4 per cent for the poorest decile to less than 1.5 per cent for the fourth poorest. Middle-income groups (the fifth to seventh deciles, adult equivalent income €247 to €428) receive the average gain of one-half a per cent. The richest 30 per cent (adult equivalent income > €428) fare the worst, experiencing a slight drop in income compared to a neutral budget.

The redistributive focus of Budget 2004 is confirmed by the cash changes in weekly disposable income. The bottom 40 per cent of the population gained between €3.50 and €5.50 per adult equivalent. The next 30 per cent got in the region of €2, while the top 30 per cent recorded a cash loss of up to €3 per week. Turning to the share out of the net additional resources over those required for wage indexation in Budget 2004 (in the region of €220 million), almost 90 per cent was allocated to low-income households, with the better off being net contributors of €40 million to this redistribution pool.

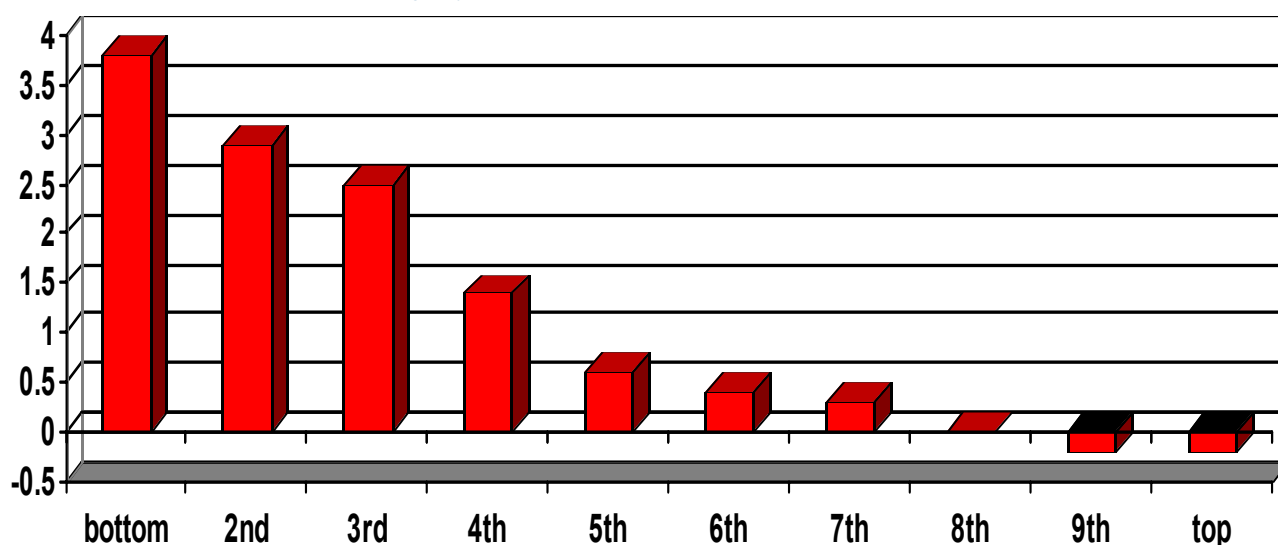
We can also look at the changes for specific types of families. In general, families on social welfare did best, with the single unemployed the greatest beneficiary of Budget 2004 with a gain of over 4 per cent. The retired and lone parents gained between 1 and 2 per cent. By contrast, most earning couples showed little change. Meanwhile, households with children fared no better, and sometimes even worse, than those without children, whatever their income source.

What explains the redistributive outcome of Budget 2004? First, the budget allocated far more resources to welfare improvements than tax reductions. In fact, when compared with the cost of a wage-indexed budget, an extra €270 million was provided for welfare measures. The tax element of the budget, while ahead of last year, was still not enough to index tax rates and bands in line with wages (a €50 million shortfall). In effect, all gains were concentrated on households in receipt of welfare, while taxpayers had to pay more of their wage-indexed incomes in taxes.

Second, the positive outcome for low-income households was enhanced by the structure of the welfare package, in particular the flat-rate increase of €10 for all welfare recipients. This increase, as well as being far ahead of wage growth (4.5 per cent more), is worth proportionally more to those on the

**Figure 1: Distributive impact of Budget 2004**

(% change by equivalised disposable income per decile\*)



\* The income range per adult equivalent of the deciles is as follows: less than €130; €130 to €150; €151 to €181; €182 to €246; €247 to €308; €309 to €361; €362 to €428; €429 to €502; €503 to €639; more than €639.

lowest welfare rate. Higher rate welfare groups such as pensioners only gained 2.9 per cent over wage indexation. As those on the lowest welfare rates are concentrated in the bottom decile (a weekly income of less than €130), their percentage gain was the highest.

Third, there were negligible gains for households with children as the child benefit increase of €6 per month was only slightly ahead of wage indexation (1.2 per cent). While child benefit is an inherently redistributive mechanism, in that the payment is worth proportionately more to low-income families, the effect in Budget 2004 was diluted by the small size of the increase. Furthermore, the modest gain derived by poorer families from child benefit was

more than clawed back by the failure to increase child dependant allowances, which remain a significant proportion of the child income support package for poor families.

Finally, while the overall tax package was less than that required to prevent a rise in the tax burden, the decision to concentrate resources on increasing the employee tax credit benefited lower-income taxpayers at the expense of the better off. This targeted increase was specifically designed to ensure that those on the minimum wage would not pay more tax when it increased from €6.35 to €7 per hour in February 2004. On the other hand, the failure to index tax bands means that higher earners will pay more tax in 2004.

## Budget 2004 in context

The distributive impact of Budget 2004 can be compared with Budget 2003, the first of this Fianna Fáil/Progressive Democrats government, and Budgets 1998 to 2002, under the previous Fianna Fáil/Progressive Democrats government. This comparative perspective enables the tax/welfare choices underlying Budget 2004 to be put in a long-term policy context.

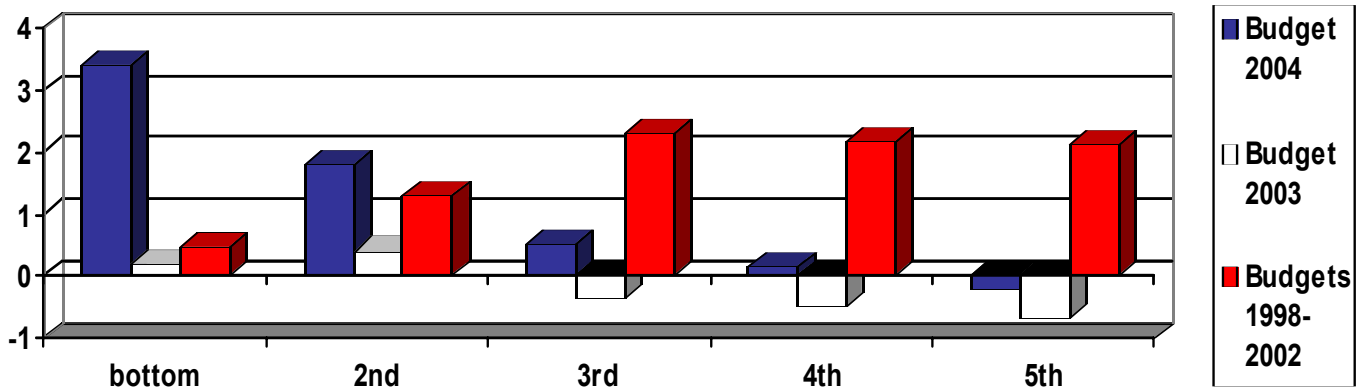
Figure 2 shows how Budget 2003 had a minimal distributive effect, with an overall percentage loss of 0.5 per cent. While lower income groups did better than the average, the gain was extremely modest at less than 1 per cent. Though the redistributive focus of Budget 2003 was retained in Budget 2004, the

bigger package of resources greatly enhanced the overall impact on poorer groups.

The tax/welfare packages during the period 1998 to 2002 delivered average annual gains of up to 2 per cent (four times that of Budget 2004). 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 1 per cent. Then, as with Budget 2004, 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.

**Figure 2: Distributive impact of Budget 2004 compared to Budget 2003 and Budgets 1998 to 2002 (annualised)**

(% change by equivalised disposable income per quintile\*)



\* The population is divided into quintiles in this diagram to facilitate comparative analysis.

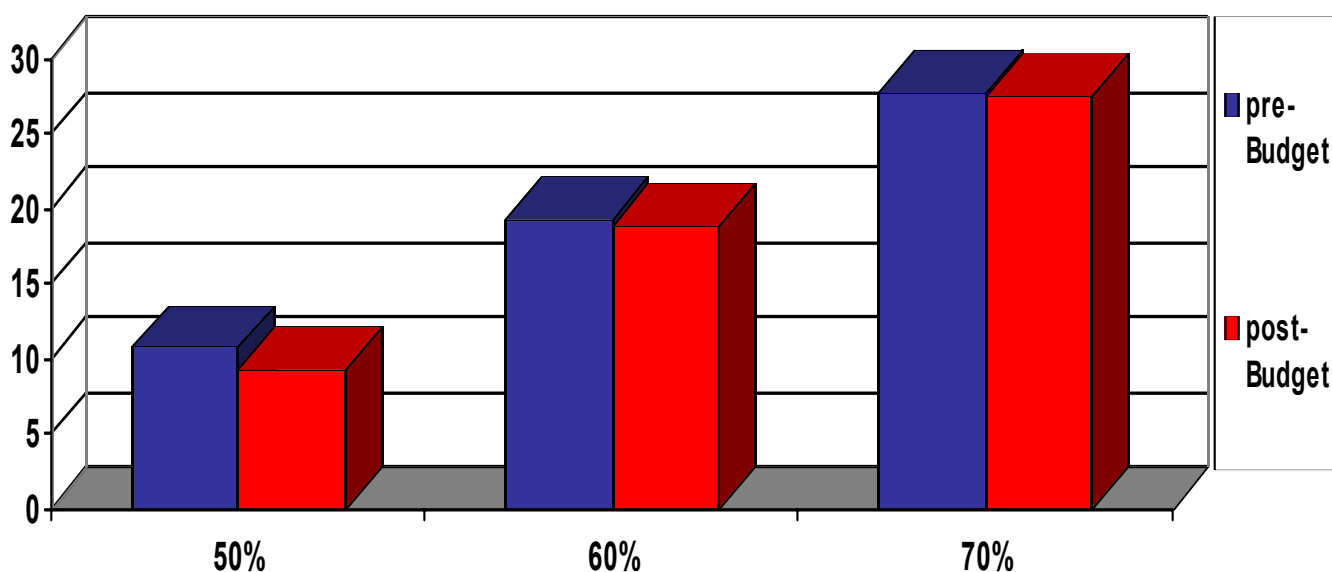
# Poverty impact of Budget 2004

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 (the adult equivalent in cash terms is €170, €204 and €238 respectively). Figure 3 illustrates the positive effect of Budget 2004 on these measures of income poverty.

The largest reduction is at the 50 per cent line, which shows a fall of 1.5 per cent. The scale of the fall at the 60 and 70 per cent lines is considerably less, 0.6 and 0.3 per cent respectively. These data are in line with the distributive pattern set out earlier, which showed that the bottom 10 per cent of the population got the greatest benefit from Budget 2004, with a smaller percentage gain for the next two income deciles.

**Figure 3: Impact on relative income poverty of Budget 2004**

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



## Broader issues in fiscal policy

This budget analysis primarily focuses on tax/welfare changes. There are other fiscal issues, however, which impact on income distribution and poverty that are not measured in this analysis.

To begin with, the welfare cuts of €55 million announced in the Book of Estimates for 2004 must be taken into account. These reductions are targeted at supplementary payments for low-income households with additional needs, i.e. private housing rents, dietary supplements and access to childcare. The changes in the rules governing these payments are likely to affect people's choices more than directly impact on their living standards. It is regrettable that the cutbacks were introduced on the

basis of reducing welfare expenditure rather than reviewing the appropriateness of the existing policy response to important social needs. Also, alternative policy measures, where they were warranted, should have been put in place in advance.

The detrimental effect of a high inflation rate on the fixed incomes of welfare recipients was highlighted in last year's analysis. This year, the inflation rate is forecast to fall to 2.5 per cent, half the rate predicted for 2003. The avoidance of any state-induced inflation, such as higher VAT rates or increased service charges, in Budget 2004 is a key contributor to the falling inflation rate. However, the 2004 rate is still among the highest in the EU, which indicates the

scope for further reduction. By keeping inflation low, the impact of the €10 per week increase in the basic welfare payment is maximised. In addition, it makes the target of an inflation-adjusted €150 minimum welfare payment by 2007 more achievable.

One area where service charges have increased as a result of government policy is waste collection, as the principle of 'polluter pays' is given full effect at local level. Recent research by Combat Poverty highlights the increased burden that these charges pose to low-income households, especially in the absence of a clearly defined waiver system.<sup>3</sup>

Waivers only exist where local authorities provide a waste collection service; and even then, there is wide divergence between local authorities as to eligibility criteria and level of waiver. As waste collection is increasingly taken over by private operators, the absence of a standard waiver system will become more acute. This is a matter for national policy to ensure that the 'polluter pays' principle is adjusted to include recognition of the variation in people's ability to pay.

The redistributive focus of Budget 2004 is clearly demonstrated in the preceding analysis, as is its positive effect in reducing income poverty. The main constraint to maximising this impact is the level of resources available for welfare improvements. One response to this would be to prioritise more of the total budgetary package for welfare expenditure, at the cost of tax reductions. This could be achieved by converting more of the potential pool of tax resources into a higher child benefit. In the last two budgets, the government target for a child benefit of €149 per month by 2003 has been sacrificed to meet other policy goals such as higher welfare payments and tax credits. While the welfare focus is justified from an anti-poverty perspective, the level of increase in tax credits is more open to question, especially when the high cost (€287 million) and the level of increase (30 per cent) are taken into account. By contrast, the child benefit package was only €80 million or 4.7 per cent of an increase. In effect, tax credits and child benefit can be seen as competing tax/welfare policy instruments at a time of scarce public resources.

The SWITCH model can be used to simulate the outcome of switching resources from tax credits into a higher child benefit payment. To meet the revised child benefit target, the actual budget increase of €6

per month would have to be doubled, at an additional cost of €80 million (total €160 million). This could have been funded by capping the employee tax credit increase at €176 rather than €240 (an increase of 22 per cent instead of 30 per cent or €207 million). The doubling of child benefit would have benefited lower-income households, while leaving middle-income groups unchanged and those with the highest income at a small loss. Child benefit, therefore, presents a better way of targeting scarce government resources at those most in need, while at the same time benefiting taxpayers with children.

The other option is to simply increase the total tax/welfare package. This was achieved in the early 2000s, when the net cost of the budget package over indexation was more than €1,000 million (four times the level in Budget 2004). Then, however, the additional resources were the product of buoyancy in tax revenues arising from high rates of economic growth. There are growing indications that tax revenue buoyancy will improve in the next few years, as the rate of economic growth picks up. However, it is unlikely to reach the record levels of previous years. Therefore, additional resources will be required from within the tax system, preferably through broadening the tax base rather than increasing rates of tax.

In this context, the high amount of tax revenue lost through discretionary tax expenditures (over €7 billion) should be reviewed. The economic and social benefits of many 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 more likely to be availed of by higher earners, who also receive a higher level of relief. As a result, some top earners have reduced their effective tax rates to below 20 per cent. The government previously signalled its determination to curtail these reliefs because of these criticisms, a view reiterated in Budget 2004. The decision to extend the life span of certain reliefs and to introduce new ones in Budget 2004 seems contrary to the stated policy position.

<sup>3</sup> Combat Poverty Agency (2003), *Waste Collection Charges and Low-Income Households*, Dublin: Combat Poverty Agency.

# Conclusion

Budget policy is important to the implementation of the National Anti-Poverty Strategy. This analysis assesses the distributive and poverty impact of the tax and welfare components of Budget 2004, using the SWITCH model. This shows that Budget 2004 enhances the progressive focus of recent budgets, delivering gains of up to 4 per cent for low-income groups against a wage-index budget, while higher earners record a small loss. Budget 2004 also has a positive effect on relative income poverty, thereby contributing to government policy targets. The key factors shaping this budgetary impact were the

prioritisation of welfare improvements over tax reductions and the substantial flat-rate welfare increase of €10. Of less importance were the modest rise in child benefit and the large increase in the employee tax credit. A reversal of priorities, whereby more resources were spent on child benefit over tax credits, would have enhanced the gains for families, especially those on low incomes. Going forward, a key policy challenge issue will be to increase the overall size of the tax/welfare package, probably by broadening the tax base.



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