



POLICY SUBMISSION

An analysis of the distributive and poverty impacts of Budget 2002

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1. Introduction

Ireland is amongst the most unequal countries in the EU, with one of the highest rates of relative income poverty.¹ What effect will Budget 2002 have on income inequality and on poverty? In answering these related questions, it is important to bear in mind that tackling poverty is only one of many policy objectives in Budget 2002. Equally, there are other policy instruments that the government can use to reduce poverty, as set out in the National Anti-Poverty Strategy. Nonetheless, the Budget remains the key policy instrument in government policy to tackle poverty:

- it sets out the government's approach to improvements in welfare payments, the key determinant of the living standards of poor households;
- its tax policies have an important bearing on income distribution, in particular on income inequalities which lead to poverty;
- budgetary policy (welfare and tax) can affect work incentives and thus impact on a key cause of poverty: unemployment;
- the Budget (in conjunction with the Book of Estimates) outlines public expenditure plans for key policy areas such as health, housing and education;
- finally, the Budget must ensure that adequate resources are collected through various taxes in order to fund welfare and other social policies.

Reflecting the above and in line with the commitment in the National Anti-Poverty Strategy to make poverty an overarching goal of public policy, the government requires that the poverty impact of the Budget is assessed prior to implementation through a mechanism known as 'poverty proofing'. To-date the approach to poverty proofing has been less than satisfactory, reflecting conceptual and data deficiencies.² In Budget 2002, these weaknesses were exacerbated by the fact that no poverty proofing analysis was presented for the welfare elements of the Budget.

Combat Poverty has been applying its own methodology for assessing the distributive and poverty impact of recent Budgets, drawing on the ESRI tax/benefit model, SWITCH.³ This enables an in-depth assessment of the income tax and social welfare changes, based on a representative sample of the population and reflecting individual and family circumstances. We now take this analysis a stage further by looking at the distributive and poverty impact of Budget 2002 in the context of the preceding four Budgets presented by this government. This enables a long-term perspective of budgetary policy and its impact on income differentials and poverty.

2. The policy context of Budget 2002

Budget 2002 was framed against a difficult set of economic circumstances. Economic growth – the engine of recent government surpluses – slowed dramatically in 2001, the consequence of Foot and Mouth and the September 11th attack on America. Meanwhile, government expenditure grew in 2001 at a rate of 20 percent. By year end, the forecast Budget surplus of 2.5 billion had all but disappeared. In this context, it was anticipated that Budget 2002 would be considerably more modest than in recent years and might even feature an Exchequer deficit.

¹ Eurostat (2001), *The social situation in the European Union 2001*, Luxembourg: Office for Official Publications of the European Communities

² T Callan et al (2001), *Reforming tax and welfare*, Dublin: ESRI; Combat Poverty Agency (2001), 'Analysis of Budget 2001', *Poverty Today Supplement*, March/April 2001, Number 50; National Economic and Social Council (2001), *Review of poverty proofing process*, Dublin: NESCC

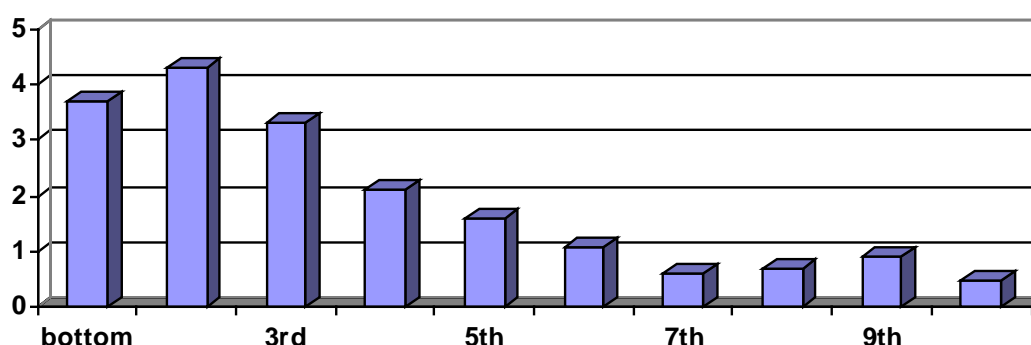
³ As described in T Callan et al (1998), *Simulating tax and welfare changes*, Dublin: ESRI. All calculations and accompanying commentary are the exclusive responsibility of the Agency and no responsibility for the results is attributed to the ESRI or the authors of the model software.

In fact, Budget 2002 delivered a tax/welfare package of €1.6 billion, with the welfare element representing the major component at €1 billion. Furthermore, the Budget achieved this without posting an Exchequer deficit. As well as the tax/welfare measures which are considered in detail below, the Budget provides for an increase in current spending of 10.5 percent, with health and education the main beneficiaries. In overall terms, Budget 2002 is seen as mildly stimulatory to the economy. However, the main determinant of economic growth will be the extent of the recovery in the global economy. The forecast growth rate for 2002 is between 3 and 4 percent, which is less than the economy's potential. Tax revenue is expected to grow by 6.5 percent.

3. The distributive impact of Budget 2002⁴

Diagram 1 outlines the distributive impact of Budget 2002 by income decile. It reveals that the average percentage gain is 1.1 per cent. This average masks a wide variation between income deciles, with the 30 percent of the population on the lowest incomes gaining up to four times this amount. As we move up the income scale, the gain falls significantly, with households in the fourth to sixth deciles getting on average 1.6 percent, while the richest 40 percent secure less than 1 percent. Budget 2002 is thus quite redistributive, with the greatest gain accruing to those at the bottom of the income schedule. At the same time, no income decile experienced an actual reduction in their incomes as a result of Budget 2002.

Diagram 1: Distributive impact of Budget 2002
(% gain by equivalised disposable income per decile)



These percentage gains can also be expressed in cash amounts, with an average gain of €5.61 per adult equivalent. Most lower income deciles got more than this amount, with the exception of the bottom decile. Only the richest two deciles got a greater cash gain, while the seventh and eighth deciles fell significantly short. It is also useful to examine how the overall package of budgetary resources were allocated between income deciles. Here we find a remarkably consistent pattern, with each decile getting a broadly equivalent share of total resources.

4. Budget 2002 in a comparative context

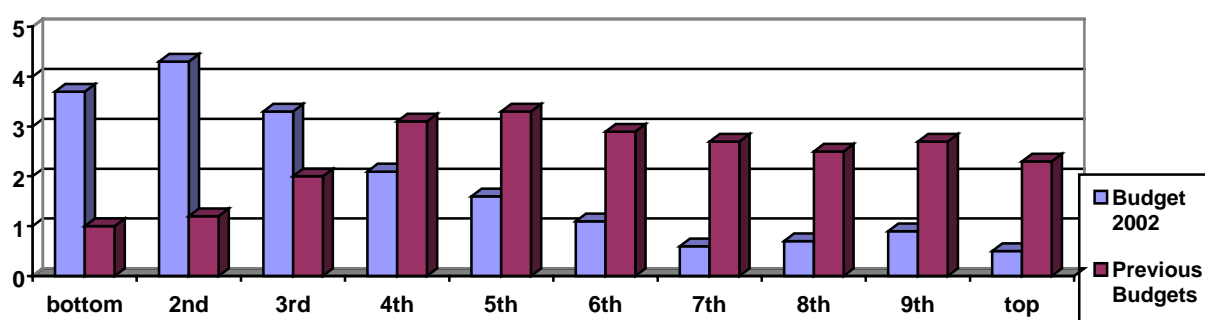
We turn now to examine the distributive impact of Budget 2002 as compared to the annualised impact of Budgets 1998-2001, also delivered by this government.

⁴ A critical issue in assessing the distributive and poverty impact of Budget 2002 is the choice of benchmark. Here we choose a distributionally neutral benchmark, which assumes equal growth in income across all groups, by indexing tax and welfare changes to the growth in gross wages.

Diagram 2 shows the unique distributive impact of Budget 2002 as compared to the previous four Budgets. The average gain for the four Budgets is 2.3 percent, which is twice the gain under Budget 2002. More significantly, the distributive effects of the Budgets are quite contrasting, especially at the extremes of the income schedule. Previous Budgets delivered above average gains for middle and higher income households, with increases of up to 3 percent. By comparison, the poorest 30 percent of the households only benefited by 1 to 2 percent. The contrast between the two budgetary periods is greatest at the extremes of the income schedule. Thus, the gain for the bottom two deciles in Budget 2002 was the equivalent of the total gains accruing from the past four Budgets. The opposite ratio applies to the top 40 percent of households: they received only a quarter of the previous years' increase in Budget 2002.

Diagram 2: Distributive impact of Budget 2002 and Budgets 1998-2001 (annualised)

(% gain by equivalised disposable income per decile)



What explains this turn-around in the budgetary distributive pattern? It is important to make clear that the level of expenditure was not the main factor. Indeed, Budget 2002 allocated only two-thirds of the amount of resources in previous years, as is reflected in the contrast between the average gains in the various Budgets. The primary cause of the altered distributive impact is the balance between tax reductions and welfare improvements in the two budgetary periods. This is illustrated in table 1. In the period 1998-2001, the vast majority (90 percent) of additional resources went to tax reductions, with a further 13 percent on child benefit. Social welfare expenditure was not sufficient to maintain payments in line with wages, our neutral benchmark. Budget 2002 reveals a changing set of policy priorities between tax reductions, child benefit and welfare increases. The tax component falls to a fifth of the total, with over half of resources going on child benefit and a further quarter on welfare expenditure.

Table 1: Breakdown of additional resources in Budgets 1998-2002 over wage indexation (€m)

Budgetary period (annualised)	Additional resources	Tax	Child benefit	Social welfare
1998-2001	719	650 (90%)	93 (13%)	-24 (-3%)
2002	472	98 (21%)	253 (54%)	121 (26%)

A secondary consideration is the specific measures supported on the tax and welfare sides. Within the tax prioritisation of Budgets 1998-2001, there was a heavy emphasis on rate cuts and widening of bands, which are less equitable than increasing tax credits. On the welfare side, the main drivers of the redistributive outcome in Budget 2002 were the increases in child benefit and welfare payments. While child benefit goes to all families, its effect is redistributive because of the flat nature of the benefit (ie it is proportionately worth more to families on a low income) and the fact that children are more likely to be in poorer families. Meanwhile, welfare increases primarily (but not exclusively) benefit low-income households as it is their main income source.

This shift in budgetary priorities prompts the question whether Budget 2002 is an aberration or a new policy direction. In answering this question, it is important to note that Budget 2002 was the end of a five-year budgetary cycle, not at the beginning. Furthermore, its pro-welfare stance occurred only after the tax commitments of the *Programme for Government* and the *Programme for Prosperity and Fairness* were met. This indicates that the policy objective of 'rewarding work and effort' is seen as more important than that of 'distributing resources fairly'. Changed priorities will be crucial if income inequalities are to be reduced, or at least not exacerbated, in future years. In particular, income redistribution should be an explicit policy goal rather than a residual issue. Another issue is the belief that wealth has to be created before we can have sufficient resources to redistribute. This is clearly not the case given the record surpluses of recent Budgets. It is ironic that it is only when resources are actually diminished that the concerns of those on the lowest incomes come to the fore.

The prioritisation of welfare expenditure in Budget 2002, even with the smallest Budget package of recent years, also highlights the missed opportunity in previous Budgets to allocate additional resources to welfare payments. During this period, when there was a much larger amount of resources available, even a 50:50 split between tax and welfare would have provided an additional €1.5 billion for welfare improvements, or five times what was spent in Budget 2002.

5. Poverty impact of Budget 2002 and Budgets 1998-2001

We now turn to the impact of Budget 2002 on relative income poverty.⁵ The backdrop to Budget 2002 was a poverty rate (as estimated by the SWITCH model) of 21 percent below half average income, with 10 percent falling below the 40 percent line and 27 percent below the 60 percent line. Building on the earlier evidence of a redistributive impact, Budget 2002 achieves a reduction in poverty of around half a percentage point, with a slightly greater fall in severe poverty (40 percent line) and less of a reduction at the 60 percent line. As well as a reduction in poverty, the extent to which households fall below the various poverty lines will also be reduced (the poverty gap).

⁵ The other measure of poverty is a combination of income poverty and deprivation of resources (referred to as consistent poverty). While the government has framed its poverty targets on the basis of consistent poverty, it is not possible to assess the budgetary effect on poverty using this measure. It is self-evident, however, that there is an important link between income and consistent poverty.

Table 2: Change in relative income poverty post-Budget 2002
(household mean income)

Poverty line	Pre-Budget 2002 %	Post-Budget 2002 %	Poverty reduction %
40%	10.29	9.49	- 0.8
50%	20.65	20.02	- 0.63
60%	26.94	26.53	- 0.41

We next look at these changes in a wider perspective, by examining the trend in relative income poverty as a result of the previous four Budgets. Again, this highlights the unique outcome of Budget 2002 compared to its predecessors. The poverty effect of Budgets 1998-2002 was to actually increase poverty at 50 percent line by 2 percent or an average of half a percentage point every year. An increase in poverty was also apparent at the 40 percent line, though not to the same extent as at half-average income. Poverty, however, fell at the 60 percent line by slightly over half a percentage point over the four years. The poverty gap worsened across all poverty lines. Budget 2002 has not alone halted this trend, but completely reversed the cumulative increase at the 40 percent poverty line and significantly ameliorated it at the 50 percent line.

Table 3: Change in relative income poverty under Budgets 1998-2001 and Budget 2002 (annualised)
(household mean income)

Poverty line	Poverty Budgets 1998-2001 %	Poverty effect Budget 2002 %
40%	+ 0.17	- 0.8
50%	+ 0.49	- 0.63
60%	- 0.15	- 0.41

6. Micro-analysis of welfare elements of Budget 2002

What are the principal features of the welfare package in Budget 2002?⁶ The outstanding element was the increase in the standard child benefit rate of €31.80 (£25), raising child benefit to €117.60 per month of €27.14 per week.⁷ This represents an increase of €6.05 per child per week ahead of wage indexation. However, the value of this increase for families on welfare is significantly diminished by the failure to allow any increase in child dependant allowances. For families in receipt of child dependant allowances for children aged 19 to 21, this loss is not offset by any gain in child benefit due to its age cut point of 19 years.

The popular impact of child benefit is more apparent in Budget 2002 than last year's Budget, as the tax reductions of the previous year are not provided, thereby making it the flagship element of budgetary policy. Also, as the second year of the planned

⁶ Table 4A details the changes in selected social welfare payments and child benefit in Budget 2002.

⁷ The increase in the higher child benefit rate (3rd or more child) was €38 or £30 per month, bringing the benefit to €147.30 per month or €33.99 per week.

trebling of the payment, its cumulative value is now more apparent as it well exceeds the €100 per month mark. Another factor is the bringing forward of the payment date to April from June. Child benefit is clearly now the mainstream policy instrument for supporting children. As shown in last year's Combat Poverty analysis, this is a much fairer route to supporting children than the advocated alternative of childcare tax relief.⁸ It also avoids the take-up and disincentive difficulties associated with means-tested payments and leaves parents decide their preferred means of childcare.

However, its success should not take away from the additional needs of some children, notably those in welfare-dependant families. The post-Budget 2002 combined rate of child income support is €44, over €4 less than the basic costs of a child.⁹ The valuable contribution that an increased child dependant allowance can make to alleviating poverty should not be ignored. The needs of low-income working families faced with high childcare costs also warrant a targeted policy response.

There is a practical issue regarding the frequency of paying child benefit. Despite the record increases, child benefit remains a monthly payment. Consideration should now be given to paying it on a fortnightly or even weekly basis, or at least giving beneficiaries this option. This is especially pertinent for poor families, where child benefit now represents 60 percent of total child income support.

On the welfare side, this Budget continues the recent policy direction of giving payment increases in line with and even ahead of wages. Welfare increases are between 8 and 10.5 per cent, well in advance of expected wage growth of 6.5 per cent. Other innovative features to note were the higher payments for those on the lowest welfare payments (€12 or 12 percent), the improvements in the qualified adult allowances (between 12.5 and 15 percent) and special increase for widows and widowers over 66 years. Despite these improvements, there was no acknowledgement of the majority recommendation of the social partnership Social Welfare Benchmarking and Indexation Group on a new welfare adequacy benchmark (based on 27 percent of gross average industrial earnings).¹⁰ This issue has been addressed to some extent in the revised National Anti-Poverty Strategy, where a cash target of €150 per week (2002 value) is set out to be met by 2007, but not a proportionate figure.¹¹

Finally, the alignment of the welfare and calendar year is to be welcomed. This gives a one-off windfall for those in receipt of welfare payments, as is the case for taxpayers whose year is brought forward to January 1st.

7. Other aspects of Budget 2002

It was noted above that the tax component of Budget 2002 was much less than in previous years, due to both the reduced share allocated to tax and the smaller scale of the Budget. This reduced pot of money was allocated in two main ways: to increase personal and employee PRSI credits by a total of €275; and to increase the single standard rate band by €2,605. Tax credits are the most equitable way to reduce income tax, unlike cuts in the tax rates or widening of the standard rate band. The gains from the widened standard rate band are curtailed, however, by the

⁸ Combat Poverty Agency (2001), *op cit*, pp 6-8

⁹ C Carney et al (1994), *The cost of a child. A report on the financial costs of child-rearing in Ireland*, Dublin: Combat Poverty Agency.

¹⁰ *Final Report of the Social Welfare benchmarking and Indexation Group*, September 2001

¹¹ Government of Ireland (2002), *Building an inclusive society. Review of the National Anti-Poverty Strategy under the Programme for Prosperity and Fairness*, Dublin: Department of Social, Community and Family Affairs.

government's policy of restricting the transferability of the rate band for married couples. The Budget also contains a number of income tax exemptions and reliefs for specific activities. The most notable of these is the re-introduction of interest relief on borrowings for rented residential investment. The cost of this measure is estimated to be €50 million in a full year. In general, income tax reliefs benefit those on higher incomes, an outcome reinforced in this case by not standard rating the relief. Equally, the social effect of the policy - an increased supply of rented housing - is not targeted at those in greatest need of private rented housing: recipients of a rent allowance.

In regard to PRSI, the main change was the 1.25 percent reduction in the rate of employer PRSI, from 12 per cent to 10.75 percent. At a cost of €347 million, this was a significant concession to employers and more than compensated for the decision in Budget 2001 to abolish the employer PRSI ceiling. A related tax change was the reduction in corporation tax from 20 percent to 16 percent, in line with government policy to eventually reduce the rate to 12.5 percent. The cost of this is €329 million. Together, these changes represent a major boost to the business sector, coinciding with the benefits it has accrued from a period of economic growth.

There are various revenue raising tax measures in Budget 2002. The main item is the restoration of the full VAT rate of 21 percent, following the 1 percent cut in VAT introduced last year (an expected yield of €290 million). Excise duties on tobacco, fuel and cider are increased, generating €300 million in government revenue. Indirect taxes are recognised as a regressive system of taxation as they affect low-income households the most. These measures will also increase inflation by 1 percent.

The Budget contained four measures designed to generate additional income for the Exchequer:

- €792 million by moving corporation tax to a current year basis
- €635 million from the Social Insurance Fund
- €610 million from Central Bank in connection with euro changeover
- €208 million from the Capital Services Redemption Account.

The most significant of these is the transfer of €635 million from the Social Insurance Fund. Together with the reduction in the rate of employer PRSI, this represents a considerable loss to the social insurance system. Previously, Combat Poverty advocated that the social insurance surplus should be used to enhance the benefits provided, such as existing optical and dental benefits and possible new schemes such parental leave or GP service. Furthermore, use of the Social Insurance Fund to generate exchequer resources undermines the philosophy of PRSI.

These exceptional measures mask the serious decline in the exchequer finances. While the Budget targets a small Exchequer surplus for 2002, it is clear that this will only be achieved by reliance on one-off measures, which are unlikely to be available in future years. This brings into focus the long-term policy direction on taxation. The Government has used the surplus of recent years to reduce taxes, while also increasing expenditure. This strategy is unsustainable in the long-term, as our pattern of economic growth moderates from its recent heights.

Finally, there are no changes made to the government's savings incentive scheme, despite the proposals from a variety of sources for the introduction of a complementary savings scheme targeted at low-income households.

8. Conclusion

Budget 2002 is set against the context of a dramatic downturn in government finances. Despite this, it delivered the most progressive tax/welfare package of recent years, with a clear favouring of households on lower incomes. The gain to these households was up to four times the average increase, while better-off households got less than half the average. This stands in stark contrast to the previous four Budgets, where middle and higher income groups were the main beneficiaries. Consequently, the boost to the living standards of the bottom fifth of the population in Budget 2002 is the equivalent of that achieved under the previous four Budgets. The knock-on effect of the redistributive philosophy of Budget 2002 is reflected in a reduction in income poverty, a significant achievement in the light of the increase in relative income poverty under previous Budgets.

The main reason for this progressive outcome was the shift in priority from tax to welfare, rather than the total budgetary allocation. This pro-welfare stance is reflected in the second consecutive €31.80 increase in child benefit and the 8-10.5 per cent increase in welfare payments, significantly ahead of forecast wage growth of 6.5 percent. Meanwhile, a more modest package of tax reductions favoured tax credits. However, other tax changes, notably the reintroduction of mortgage relief for residential investment and the increase in indirect taxes, are regressive.

Two main policy questions emerge from the analysis. The first is whether the redistributive focus of Budget 2002 is a one-off or a new policy direction. Crucial here will be the extent to which future policy embraces income redistribution as a core concern, rather than a residual matter to other policy priorities. Having indicators (if not targets) to measure income inequality and income poverty, as proposed by the EU under the national action plans on poverty, will assist in highlighting this issue. The second policy issue is the long-term deterioration in the public finances, as the benefits of record economic growth begin to dry up. Large exchequer surpluses have allowed policy to both increase expenditure and cut taxes. This is not sustainable in the future, if a return to borrowing is to be avoided. If we are to have adequate welfare payments and quality public services, then a long-term strategy which provides the necessary revenue resources is required. The fact that Ireland takes a lower share of national income in taxes compared to other EU member states points to the scope to increase government revenues. A re-evaluation of business taxes, both corporation and PRSI, would be an obvious starting point.

Table A4: Changes in selected social welfare payments and child benefit in Budget 2002

Payment	2001 rate	New rate	% increase
Old Age Pension (NC)	121.26	134.00	10.5
OAP (NC) qualified adult	77.07	88.50	14.8
One-Parent Family Benefit	108.56	118.80	9.4
OPFB child dependant allowance	19.30	19.30	0.0
Unemployment Assistance	106.66	118.80	11.4
UA qualified adult	68.57	78.80	14.9
UA child dependant allowance	16.80	16.80	0.0
Child Benefit (1-2 child)	85.80	117.60	37.1
Child Benefit (3+ child)	109.20	147.30	34.9