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How budgetary policy has shaped the Irish income tax system

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Introduction

The public finances in Ireland have undergone considerable change in recent years. While there has been emphasis in policy discussions on the government deficit and debt ratios, tax performance and structure have also received attention (see, for example, O'Connor, 2013; O'Leary, 2010). In this article the focus is on income tax developments from the mid 1990s to 2013, with the aim of describing how income tax revenue has evolved and how tax policy has affected its value and sources over time. Changes in average tax rates for different gross income values over the years are also shown.

General income tax developments from 1996 to 2013 are examined initially. The impact of budgetary policy on average income tax rates and the income tax base is then considered. The financial statements accompanying the Budgets give an insight into the motivation for the income tax changes that have occurred over time. Finally, in order to place Ireland's income tax system in an international context, a cross-country comparison of average income tax rates for single persons is provided.

The main conclusion is that by 2013 the higher rate of income tax in Ireland took effect for a (representative) single/non-married taxpayer at just below average earnings while the income tax base itself was small relative to the number who could pay income tax, as a large proportion of tax units, or cases, were exempt from paying tax (excluding the Universal Social Charge (USC)). This latter feature of the income tax system was an outcome of increasing tax credits during the period from 1999 to 2009. Reducing the tax base means that in order to raise a given amount of income tax revenue, those who pay tax will have to pay a higher average rate. In recent years the introduction of the USC has reduced the proportion of taxpayers exempt from paying income tax.

Income tax revenue developments since 1996

Using the Exchequer's cash-based accounting standard shows income tax as a proportion of total tax revenue varying in a range of 27 per cent to 42 per cent between 1996 and 2013 (Figure 1). Income tax's share of total tax revenue declined from the late 1990s onwards, reaching its lowest values in the mid 2000s.[1] It has increased strongly in recent years, reaching a value of 42 per cent in 2013. This rise has been aided by the introduction of the USC.

The relative decline of income tax from 1996 until 2006 occurred against a backdrop of a rise in the number of income tax cases, at an average of 5.2 per cent per tax year up to 2007 (Figure 2).[2] During the 2000s the average real income tax take per case was at its highest in 2001 (Figure 3), although real income would have been increasing after 2001.[3] There has been an increase in average real tax revenue per tax case since 2010. The average income tax take is dictated by budgetary policy, and mainly by the values of general tax bands, allowances/credits and tax rates.[4]

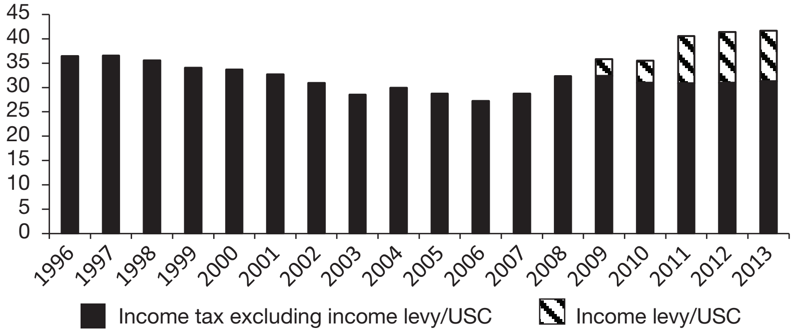
[1] Proceeds from the Voluntary Disclosure Scheme are excluded from the 2002 income tax take.

[2] The total number of tax cases includes those income earners who, because of the tax code, pay no income tax. The total number of tax cases excluding those not paying tax is referred to here as the income tax base.

[3] Figure 3 draws on the data underlying Figures 1 and 2. It only covers the years after 2000 because Figure 1 data prior to 2001 were on a calendar-year basis while those in Figure 2 were reported on a cross-year basis.

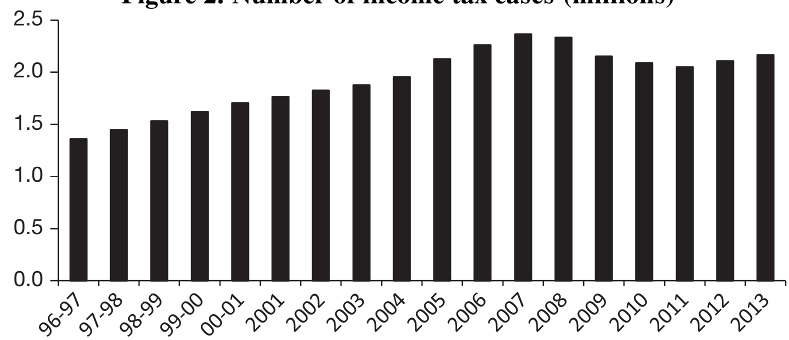
[4] Discretionary, as opposed to mandatory, income tax reliefs such as mortgage interest relief are not considered here. Compared to general income tax measures (bands, allowances/credits and rates), changes in these reliefs tend to have a small impact on income tax revenue.

Figure 1: Income tax revenue (percentage of total tax revenue)



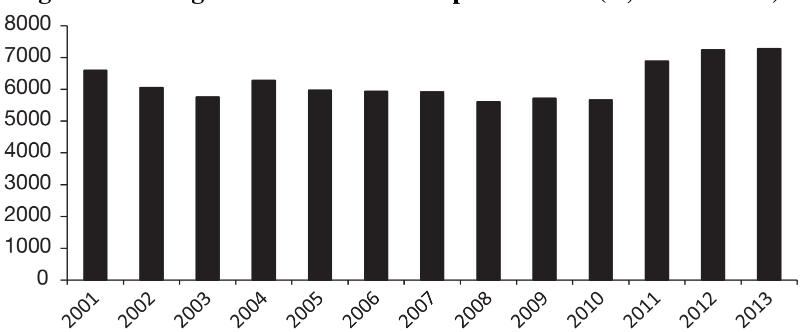
Sources: Department of Finance: end-year Exchequer returns; Revenue Commissioners: Annual Reports (for USC component).

Figure 2: Number of income tax cases (millions)



Sources: Revenue Commissioners: Statistical Reports; Department of Finance: Budget books.

Figure 3: Average income tax revenue per tax case (€, 2013 Prices)



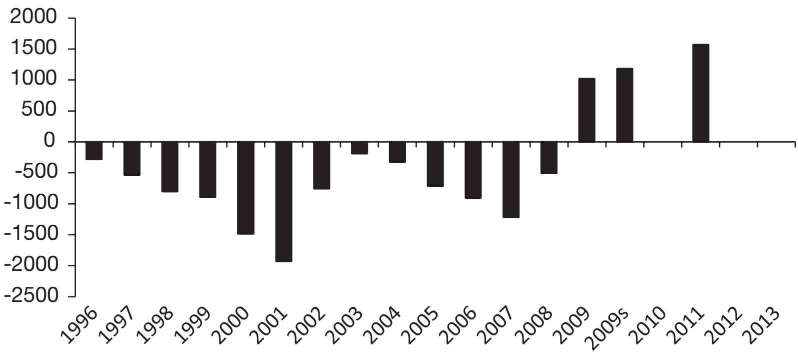
Sources: Department of Finance: end-year Exchequer returns and Budget books; Revenue Commissioners.

Budgetary policy and its impact

In Figure 4 the net cost/benefit to the Exchequer of all general income tax measures in the Budgets from 1996 to 2013 is shown (as estimated on a full-year basis by the Department of Finance at the time they were presented to parliament, but adjusted here to 2013 prices). Up to 2009, Budgets introduced income tax policies which, in net terms, reduced the income tax take.

The transition to a standard rate bands-and-credits income tax system commenced in the 1999 Budget and was completed in 2001. From 1999 to 2009 (the most recent year in which the standard rate bands or credits were increased), the relative cost to the Exchequer of reductions in the standard and higher rates of income tax was much lower than that associated with increases in tax credits (personal credit and employee credit) and the standard rate bands. The changes in tax rates only accounted for 17 per cent of the total estimated cost of income tax changes during this period, while tax credit measures had a 54 per cent share and changes in the standard rate bands accounted for 29 per cent.[5]

Figure 4: Net full-year cost of income tax package in Budgets (€million, 2013 prices)



'2009s' designates the 2009 Supplementary Budget.

Sources: Department of Finance: Budget books; CSO.

[5] The method of calculation of these shares is as follows: the full-year estimate by the Department of Finance of the cost to the Exchequer for each form of income tax measure in each Budget from 1999 to 2009 is adjusted to 2013 prices. The cost of the tax measures under each of the four categories is then aggregated over the years 1999 to 2009 and their relative shares for the period are calculated.

Reductions in tax rates had a relatively low cost to the Exchequer while increases in tax credits were much more costly than the changes in the standard rate bands that occurred during the 1999–2009 period.[6] This reflected larger percentage rises in tax credits than standard rate bands. So, for example, with a standard rate of tax of 20 per cent in place, the first €9,525 of a single person's income (or 38 per cent of the standard rate band) would have been exempt in 2001, owing to the size of tax credits. In 2009 the exempt amount would have been €18,300, or 50 per cent of the standard rate band, as a result of increases in tax credits in the intervening years.[7]

By 2009, income tax receipts, and tax revenue in general, were in decline, and had been since 2006. The public finances also experienced a sharp deterioration in the late 2000s and it was deemed necessary by the government to increase taxation and reduce government expenditure in annual Budgets.[8,9] Among the measures taken were ones with the purpose of raising the amount of income tax revenue. The 2009 Budget was the first since 1996 that saw changes in the general income tax code, providing a net benefit to the Exchequer (see Figure 4), owing to additional proceeds from the income levy exceeding the standard rate band increases provided for in the Budget. Subsequent Budgets saw a further increase in the income levy (2009 Supplementary Budget), reductions in standard rate bands and tax credits (2011 Budget), and the introduction of the USC (also in the 2011 Budget). The effect of these measures has contributed to the rise in income tax revenue in recent years.

An indication of how budgetary policy has impacted average tax rates across different income levels over time is provided in Figure 5. The general income tax codes for 1996 and 2003 are applied – allowing for general price indexation between those years and 2013 – to a range of gross incomes (all assumed to be paid to single/non-married

[6] After 2001, the 2007 Budget was the only one where an income tax rate was reduced – in this case a 1 per cent decline in the higher rate, to 41 per cent.

[7] For space considerations, we do not examine average tax rates for married couples but use single persons as representative taxpayers.

[8] The general government Budget balance went from a surplus of 0.2 per cent of GDP in 2007 to a deficit of 7 per cent the following year. Larger deficit ratios were recorded in 2009 and 2010.

[9] In response to the deterioration in the public finances, two Budgets were presented to parliament for the year 2009. The 2009 Budget, presented on 14 October 2008, was followed by a Supplementary Budget on 7 April 2009.

taxpayers) and compared to the equivalent tax rates under the 2013 general income tax code.[10, 11] It shows that average tax rates were much higher under the 1996 tax code than under the 2003 tax code. The introduction of the USC and reduction in the standard rate tax band and tax credits in recent years mean that average tax rates were higher under the 2013 income tax code compared to that of 2003, but lower than under the 1996 tax code.

Figure 6 shows that, between 1996 and 2013, those on lower salaries benefited most from income tax reductions in terms of average income tax rate paid, with, for example, an individual earning €20,000 gross salary having an average tax rate 11 percentage points lower under the 2013 tax code compared to that which would arise if the 1996 income tax code was in effect. A single person earning €80,000 would have seen his/her average tax rate decrease by 5 per cent. These comparative changes reflect a general effect of income tax policy during this period: the widening of the standard rate band would have benefited those on higher incomes more but the rise in tax credits would have disproportionately benefited, in terms of average tax rate paid, those within the standard rate band.

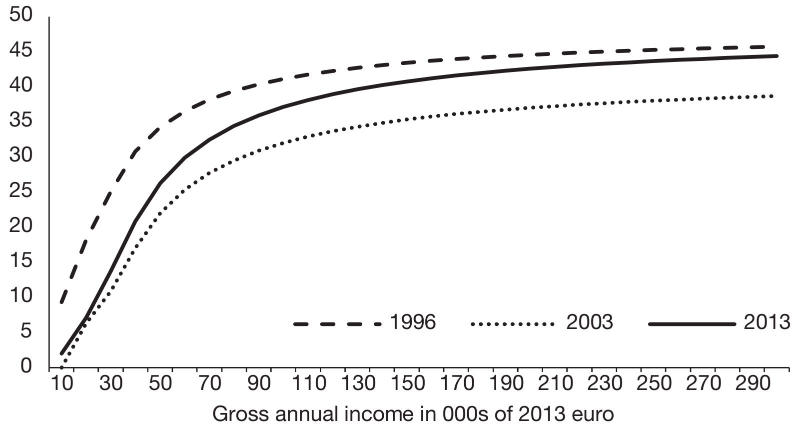
Many whose incomes (both single and married taxpayers) were within the standard rate band would have moved from a situation of paying some tax to paying none. The rising proportion of taxpayers (single and married) exempt from paying income tax over time is illustrated in Figure 7. It divides the number of income tax cases (see Figure 2) into three categories: the proportion who were exempt from income tax in the given tax year; those whose marginal tax rate was the standard rate; and those whose marginal rate was the higher rate of tax. The proportion of taxpayers exempt from paying tax increased from 24 per cent in 1996–7 to 45 per cent in 2010. It declined subsequently and stood at an estimated value of 40 per cent in 2013. The other salient feature of Figure 7 is the reduction in the percentage

[10] This approach has also been used by Honohan (2009).

[11] The calculations in Figures 5 and 6 involve the application of the general income tax code alone (i.e. excluding items such as mortgage interest relief, home carer tax credit, etc., which depend on an individual's or couple's own circumstances) to representative income values across a range of gross incomes, at €10,000 intervals, up to €300,000. The 1996 income tax calculations would have involved income tax rates in that year and price-indexed personal and employee allowances. For the 2003 computations, the relevant rates, indexed allowances and indexed tax credits would have been applied. For the 2013 calculations, the relevant rates, allowances and tax credits alone would again have been used and the impact of the USC on average tax rates across the gross income range would also have been included (it did not apply in the 1996 and 2003 tax codes).

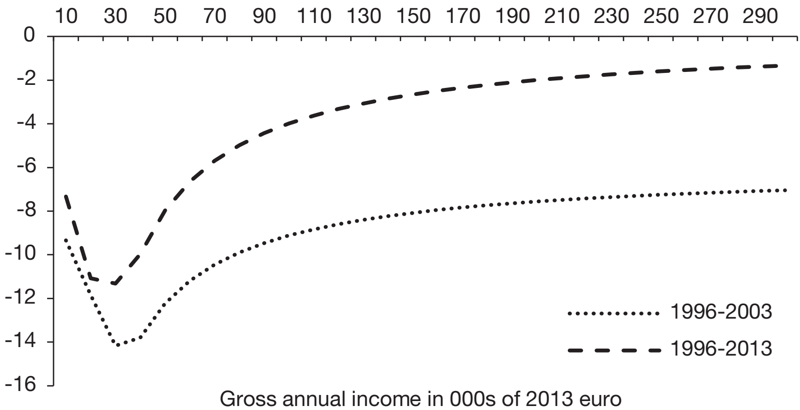
of income tax cases who paid some part of their tax bill at the higher rate during the 2000s. Between 2004 and 2010 that proportion declined from 32 per cent to 13 per cent. It rose subsequently, taking a value of 17 per cent in 2013.[12]

Figure 5: Average income tax rate (percentage of income)



Source: Authors' calculations based on Department of Finance and CSO data.

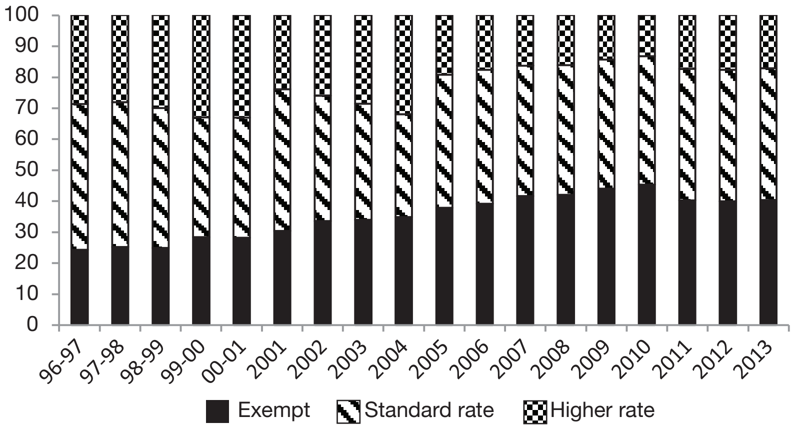
Figure 6: Changes in average income tax rate (percentage of income)



Source: Authors' calculations based on Department of Finance and CSO data.

[12] The data in Figure 7 reflect the non-USC component of income tax revenue only. The Revenue Commissioners have recently reported income earners by USC rate for 2012. The data indicate that 14.2 per cent of earners in that year were exempt from the USC; 21 per cent were paying at the 4 per cent rate; 64.2 per cent were paying at the 7 per cent rate; and 0.5 per cent were paying the 3 per cent surcharge.

Figure 7: Distribution of income tax payers (per cent)



Sources: Revenue Commissioners (up to 2012); Department of Finance: 2014 Budget (for 2013 data).

Motivation for changes to income tax code

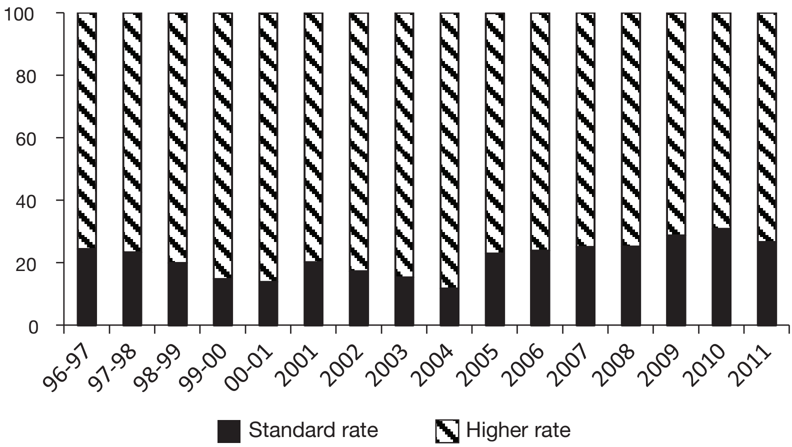
The increase in the number of income tax cases exempt from paying tax during the 2000s was in line with budgetary policy. A recurring theme of the 1999–2007 Budgets (as documented in the financial statements accompanying the Budgets) was a desire to remove many low-earners from the 'tax net'. By the time of the 2007 Budget, with the various income tax changes that had occurred in previous years, the Minister for Finance was able to say in his financial statement that the income tax system would now 'meet the commitment to keep those on the minimum wage completely out of the tax net'. He continued that this 'means that nearly two out of every five earners (or 846,000 persons) will be outside the tax net in 2007 compared to one third (or 677,000 persons) in 2004 and one quarter (or 380,000) in 1997'.

More recently, there has been a different emphasis in the financial statements in those Budgets where there have been income tax changes. The income levy, for instance, would 'allow all income earners to contribute in a proportionate manner to the restoration of order and stability to the public finances' (2009 Budget), while it was noted in the 2009 Supplementary Budget statement that a 'key weakness of the Irish [income] taxation system is the narrow base… too many did not pay tax at all'.[13]

[13] Budget speeches from 2005 to 2011 are analysed in Considine & Coughlan (2013).

Reductions in personal tax credits, the employee tax credit and the standard rate bands in the 2011 Budget had the effect of bringing some tax cases into the tax net. Notwithstanding these changes, 40 per cent of income tax cases remained exempt from paying income tax in 2013 (excluding the impact of the USC). Moreover, the most recently available data indicate that over 70 per cent of income tax revenue in 2011 accrued from those whose marginal income tax rate was the higher rate (Figure 8).[14] The USC, however, has resulted in a widening of the tax base, with only 14.2 per cent of tax cases exempt from paying it in 2012. It is a progressive tax whose marginal rate increases with income.

Figure 8: Source of income tax revenue (per cent)



Source: Revenue Commissioners.

International comparison

The OECD provides a regular publication that allows comparison of average income tax rates across different countries (see OECD, 2014). For single persons with no children, average tax rates for those on 67 per cent, 100 per cent and 167 per cent of average gross wage earnings in 2013 are shown in Figure 9. The countries covered are Austria

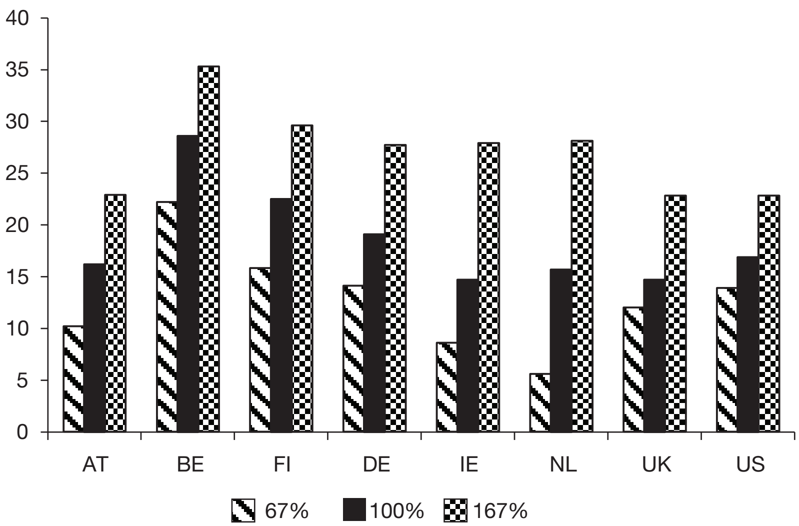
[14] The data in Figure 8 are from Table IDS17 in the 'Income Distribution Statistics' section of the Revenue Commissioners' Statistical Reports series, which concluded their income tax coverage for the year 2011. That table excludes coverage of USC receipts and its distribution among taxpayers (USC was collected from 2011 onwards).

(AT), Belgium (BE), Finland (FI), Germany (DE), Ireland (IE), the Netherlands (NL), the UK and the US.

For the representative low-income value (67 per cent), Figure 9 indicates that Ireland's average income tax rate was second-lowest of the eight countries (the Netherlands had the lowest). At 100 per cent earnings, Ireland's average tax rate was joint-lowest with the UK. For above-average incomes (represented by the 167 per cent value), Ireland's average tax rate was well above those in Austria, the US and its closest neighbour, the UK. Only Belgium had a noticeably higher average tax rate at this income level.

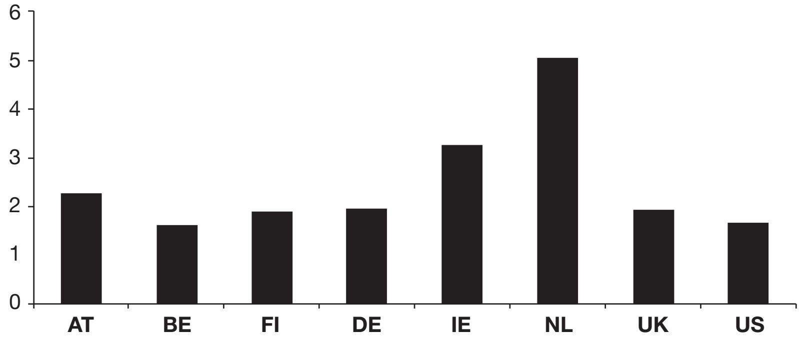
A measure of the progressive nature of the income tax system can be provided by dividing the average tax rate for the 167 per cent income level by that for the 67 per cent income level. The values for the eight countries are shown in Figure 10 and indicate Ireland to have been second among the eight in terms of this measure of progressiveness in 2013. O'Connor (2013) has commented previously on these features of the Irish tax system. He noted that Ireland is 'an outlier internationally in terms of rapid progression to the highest marginal rate' (p. 511).

Figure 9: Average income tax rates, 2013 – Cross-country comparison (per cent)



Source: OECD (2014).

Figure 10: Measure of progressiveness of income tax systems, 2013



Source: Authors' calculations using OECD (2014) data.

Conclusion

This article has examined the impact of budgetary policy on income tax revenues and the incidence of that tax from 1996 to 2013.[15] The most costly of tax policy initiatives to the Exchequer between 1999 and 2009, a period of net reductions in income tax, related to rises in tax credits and tax bands. One consequence of the income tax policies of that era was a generalised decline in average tax rates across the income range from 1996 values, although this has been reversed in part in recent years.

Analysis of the data indicates that the greatest beneficiaries among single persons of the changes in the income tax code between 1996 and 2013 were those on incomes close to median values.[16] The proportion of income tax cases (both single and married) who were exempt from paying tax was 40 per cent in 2013, compared to 24 per cent in 1996. Ireland's average income tax rate at a representative below-average income is relatively low and the Irish income tax system is relatively progressive by international comparison.

A consequence of tax policy exempting tax cases from paying tax is that in order to raise a given amount of income tax revenue, those who are not exempt must pay more tax. For example, in 2013 the higher

[15] Income tax policy will also likely have an effect on labour market participation rates and migration, but those issues are not considered here.

[16] According to the most recent data available from the Revenue Commissioners (2014), the median income for a single taxpayer in 2011 would have been in the range of €20,000–25,000.

rate of income tax for a single person in Ireland applied to income above €32,800. Average weekly earnings in all sectors of the economy other than agriculture, forestry and fishing in 2013 were €688.50 per week (Central Statistics Office, 2014), or about €36,000 per annum, so the higher rate took effect at below-average income values. Single persons on the average industrial wage in 2013 also paid the USC at the highest marginal rate.

Disclaimer

The authors are economists in the Central Bank of Ireland. The views expressed in this article are those of the authors and are not necessarily those of the Central Bank or the European System of Central Banks.

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