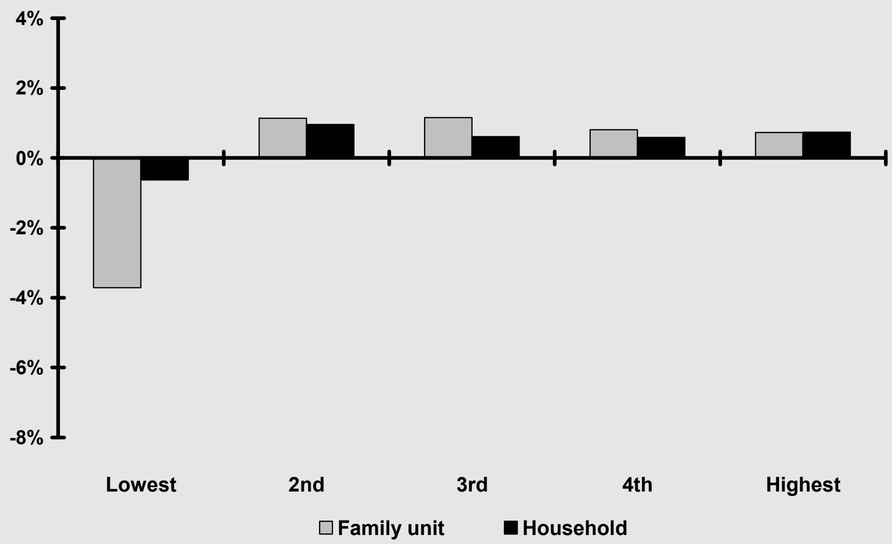
Box 2: Distributional Impact of Tax and Welfare Policy Changes by T. Callan, C. Keane and J.R. Walsh

We have argued consistently that the distributional impact of tax and welfare changes must be assessed against a benchmark which is "distributionally neutral".[17] The conventional opening budget measures changes against a scenario in which tax and welfare parameters are frozen in nominal terms. This is not a neutral benchmark: in periods of growth it would mean that welfare recipients would not share in growth, while in current circumstances, with wages (and prices) falling, the relative incomes of welfare recipients would increase if welfare rates remained the same while other incomes fell. A budget indexed to changes in wages has been shown to approximate a neutral benchmark, against which policy changes can be measured, and we continue to use this consistent framework in assessing the impact of policy changes. We look first at the impact of Budget 2010, and then at the cumulative impact of the Budgets for 2009 and Budget 2010. The analysis includes the impact of the public service pension levy, but does not, at this stage, include the recently announced public sector pay cuts.[18] Each of these would involve further substantial variation in impacts within income groups. Here we concentrate on average effects across income groups.

Figure A: Distributional Impact of Budget 2010 versus Wage Indexation (-2.5%)



Note: Family units or households are divided into 5 equal sized groups, ranked by from lowest to highest incomes (adjusted for family/household size and composition)

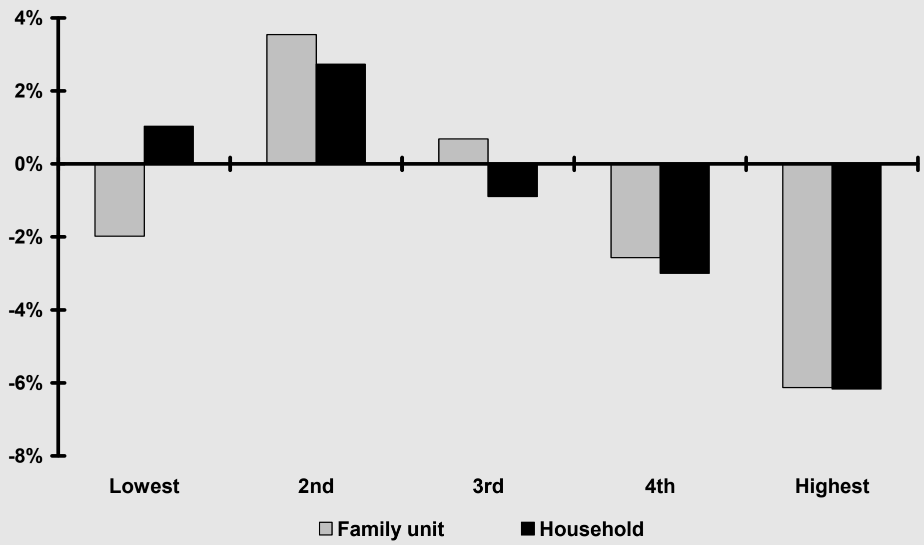
Figure 1 shows the distributional impact of Budget 2010, measured against a benchmark which indexes of tax and welfare parameters with respect to the 2.5 per cent fall in wages forecast in this *Commentary*. Analysis at family unit level (which groups children of school age or below along with third level students living in the parental home) finds that there is a decline of over 4 per cent for the lowest income quintile. Much of this effect is driven by the very sharp reductions in Job Seeker's Allowance for

[17] T. Callan, M. Keeney and J.R. Walsh "Income Tax and Welfare Policies: Some Current Issues" in T. Callan and D. McCoy (eds.) *Budget Perspectives 2002*.
[18] Analysis of the distributional impact of public sector pay cuts is now under way.

those aged under 25. The full rate of payment is €196, but this is reduced by close to 25 per cent for those aged between 22 and 24, and by almost half for those aged 20 or 21[19] Many of the young people on Job Seeker's Allowance are living in the parental home, and their entitlements were already subject to a reduction depending on familial means. Young adults, whether at work or claiming welfare, count as separate family units within the larger household.

Official targets for reductions in the numbers in poverty[20] are typically measured at household level.[21] For this reason it is of interest to examine the distributive impact of Budget 2010 measured at household level. Here the impact on the lowest income group, relative to a wage-indexed budget, is much less severe: a fall of 1.5 per cent. For other income quintiles there are very small gains, with the gain at the top reaching 0.5 per cent. This reflects the fact that tax credits, for example, were frozen rather than being reduced in line with wages and that welfare rates for the elderly remained unchanged.

Figure B: Combined Distributional Impact of Budgets 2009 and Budget 2010 versus Wage Indexation (-3.5%)



Note: Family units or households are divided into 5 equal sized groups, ranked by from lowest to highest incomes (adjusted for family/household size and composition)

Figure 2 shows the results of a similar analysis for the consolidated Budget for 2009 and the recent Budget 2010. Taken together, these budgets can be seen as representing the consolidated policy response to the recession. Budget 2009 included a 3 per cent rise in the main welfare payment rates, and substantial increases in taxes and levies, including the public service pension levy. Once again, the impact on those at lowest incomes differs depending on the unit of analysis. The poorest family units see a drop in income of about 3 per cent, but the average income of the poorest households hardly changes. On either measure there are gains (of 2 or 3 per cent) for the next quintile, which contains many of those with

[19] The payment rate for those aged 18 or 19 had already been reduced by about half in April's Supplementary Budget for 2009.
[20] This applies equally to both the Irish government's measure of "consistent poverty" and the EU's headline indicator of numbers "at risk of poverty".
[21] Most academic research on poverty is also conducted at this level.

State pensions, which remained unchanged. There have been substantial falls for the top end of the income distribution (about 6 per cent for both households or family units) and for the quintile with the second highest incomes (losses of about 3 per cent). These losses arise mainly from the income taxes and levies (including the public service pension levy) imposed in April 2009's Supplementary Budget.

Thus, while Budget 2010 is clearly regressive, with, the combination of Budgets 2009 and 2010 put the greatest burden of adjustment on those with highest incomes. The position of those with the lowest incomes depends to a significant extent on whether this is measured at household level, or at the narrower family unit level. On average there is a 3 per cent reduction in the incomes of the poorest 20 per cent of family units, which includes many young unemployed people affected by the sharpest reductions in welfare payments. However, the average effect on the poorest 20 per cent of households is slight.