14. The impact of tax and benefit reforms to be implemented in April 2008

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Summary

- Several big changes to the tax, tax credit and National Insurance systems were announced in last year's Budget and Pre-Budget Report to be implemented this April. These involve tax cuts and tax credit increases worth £14 billion in the coming fiscal year, offset by tax increases of roughly the same amount. This is the biggest set of changes to be implemented in any one year under Labour.
- Households at the top and bottom of the income distribution will gain most from the changes to personal taxes and tax credits, while those in the middle will see very little impact. But increases in taxes that we cannot allocate to specific households (such as corporation tax) are likely to reduce these gains at the top and bottom of the income distribution and may result in net losses in the middle.
- The reforms to the direct tax system are a welcome simplification of the structure of marginal rates, although further simplification would be desirable. Cutting the marginal rate for basic-rate taxpayers will improve incentives to work and to save very slightly for many individuals, but the package will not reduce the very high marginal tax or deduction rates faced by those with the weakest work incentives.
- Taking this April's changes into account, the tax and benefit reforms since 1997 will have increased the incomes of the poorest tenth of the population by 12.4% (£1,300 a year) and reduced those at the top by 5.5% (£4,200 a year) on average. Despite facing higher net taxes, a household in the middle of the top tenth of the income distribution has still enjoyed an increase in real post-tax income of around 20% between 1997 and 2006.

14.1 Introduction

The first week of April 2008 will be a big week for the British tax system. Major reforms, primarily announced in the March 2007 Budget and October 2007 Pre-Budget Report, are due to take effect for capital gains tax, corporation tax, income tax, inheritance tax, National Insurance contributions, national non-domestic rates and the tax credit system.

Taken individually, the various tax and tax credit changes would create large numbers of significant winners and losers. But the overall package appears to have been carefully constructed to minimise the number of individuals losing or gaining significantly. In particular, those aged 65 or over and families with children have been protected from losses as the system is simplified. In aggregate, the package is also fiscally neutral, with almost every pound given away with one hand being taken back with the other.

In this chapter, we analyse the set of reforms to income tax, National Insurance, tax credits and fuel duty, with a focus on the marginal rate structure and the distribution of income. Section 14.2 summarises the reforms announced for April 2008 and gives their costs. Section 14.3 analyses the impact of the changes in income tax and employees' National Insurance on the marginal rate structure for some example families, whilst Section 14.4 focuses upon the differential impact of the reforms over the income distribution and across household types. Section 14.5 places the reforms in the context of the distributional impact of all the Labour Government's tax and benefit reforms since 1997. Section 14.6 concludes.

14.2 The changes due in April 2008

Table 14.1 lists the main reforms due to be implemented in 2008–09, showing estimated gains and costs to the Treasury in both 2008–09 and 2009–10.[1] Those in *italics* are included in our main distributional modelling, which we detail in Section 14.4.

It is important to note that the Treasury presents costs on a 'National Accounts' basis. For most taxes, this means accounting for a tax when the liability accrues, rather than when the revenue is actually received by the government. However, there are some important exceptions, including corporation tax, self-assessment income tax, inheritance tax and capital gains tax. This means that the figures listed for 2008–09 do not record the full impact of all the reforms due in 2008–09, as a significant part of the revenue, particularly for corporation tax changes, will not be received and accounted for until the following year. Hence, the full impact of reforms due in 2008–09 is not reflected in the figures until at least 2009–10, but these later figures also include the impact of later reforms and economic growth. In many cases, as we wish to measure the impact of the 2008–09 reforms at the time when the tax liability accrues, the number we want lies somewhere between the two figures.

In this chapter, we focus on the reforms to income tax, National Insurance, tax credits and fuel duty. Of these, the most important in revenue terms are the abolition of the 10p starting rate of income tax for non-savings income, which raises over £8.6 billion by 2009–10, and the reduction of the basic rate of income tax from 22 pence to 20 pence in the pound, which is estimated to cost £9.6 billion by the same date. Partly in order to reduce the number of net losers from these two reforms and the £1.5 billion increase in National Insurance payments by those with higher earnings, and partly to help meet its targets on poverty, the government is increasing age-related allowances for those aged 65 and over, at a cost of almost £1 billion, and increasing the generosity of the child and working tax credits by £1.7 billion (both measured in 2009–10). Together, these reforms represent a net cost to the Treasury (and thus

[1] The complete list of tax and benefit reforms announced in the 2007 Budget and the 2007 Pre-Budget Report can be found on the Treasury website, along with the estimated costs and gains. Sources: Appendix A of HM Treasury, *Financial Statement and Budget Report 2007*, March 2007 (http://www.hm-treasury.gov.uk/media/D/0/bud07_chaptera_235.pdf); Annex B of HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 (http://www.hm-treasury.gov.uk/media/F/9/pbr_csr07_annexb_305.pdf).

Table 14.1. Tax and benefit changes in April 2008 (unless otherwise stated)

	2008–09 gain (cost)	2009–10 gain (cost)
Announced in Budget 2007		
Income tax and National Insurance		
Removal of 10% starting rate of income tax on non-savings income	*7,230*	*8,630*
Reduction of basic rate of income tax from 22% to 20%	*(8,090)*	*(9,640)*
Increase in allowances for those aged 65 and over by £1,180 above indexation	*(810)*	*(950)*
Rise in upper earnings level for National Insurance contributions by £75 per week above indexation (in 2009–10, it will be further raised to the level at which higher-rate tax becomes payable)	*1,100*	*1,490*
Tax credits		
Increase in child element of child tax credit by £150 p.a. over indexation	*(880)*	*(1,020)*
Increase in working tax credit threshold of £1,200 p.a.	*(1,310)*	*(1,310)*
Increase in withdrawal rate for tax credits of 2% points to 39%	*600*	*620*
Duties and environmental taxes		
Increase in petrol duties of 2p per litre (nominal)[a]	*350*	*375*
Other reforms	560	790
Corporation tax and national non-domestic rates		
Tax cuts: reduction in corporation tax main rate, increase in long-life capital allowance, introduction of £50,000 annual capital allowance	(1,615)	(3,540)
Tax rises: small companies' rate increased from 20% to 21% in 2008–09 and 22% in 2009–10, reduced capital allowance, abolition of empty property relief for non-domestic property	2,895	4,255
Other measures[b]	(90)	(60)
Announced in Pre-Budget Report 2007		
Tax credits		
Increase in child element of tax credit by a further £25 p.a.	*(30)*	*(30)*
Inheritance tax and capital gains tax		
Introduction of a transferable inheritance tax allowance for married and civil-partnered couples	(1,000)	(1,200)
Capital gains tax: 18% tax rate replacing current schedule from 40% to 22% for 'non-business' assets rates and 40% to 10% for 'business' assets	350	750
Other measures (including 'anti-avoidance' measures)	365	555
Total impact of 2008–09 reforms	(470)	(285)

[a] Derived using HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, October 2007 (http://www.hm-treasury.gov.uk/media/1/F/pbr_csr07_taxreadyreckoner.pdf) as the impact of the real increase taking place in April 2008.

[b] Many of the other measures included in Budget 2007 were implemented that April or are due in April 2009 and are not included.

Sources: Appendix A of HM Treasury, *Financial Statement and Budget Report 2007*, March 2007 (http://www.hm-treasury.gov.uk/media/D/0/bud07_chaptera_235.pdf); Annex B of HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 (http://www.hm-treasury.gov.uk/media/F/9/pbr_csr07_annexb_305.pdf); author's calculations.

a giveaway to households) of almost £2.2 billion in both 2008–09 and 2009–10 according to its figures (as in Table 14.1).[2]

But this giveaway is largely offset by increases in corporation tax and capital gains tax, and the overall net cost to the Treasury for the measures to be implemented in April is less than £0.5 billion in 2008–09 and £0.3 billion in 2009–10. Given that ultimately all taxes are borne by individuals, this means that the gains (losses) for different deciles or household types that we find in our distributional analysis should be adjusted downwards (upwards) to give an idea of how the whole package is likely to affect net household incomes.

The gross tax rises and reductions (the latter including tax credit increases) amount to about £13.5 billion and almost £14.0 billion respectively in 2008–09, and to more than £17.6 billion and £17.9 billion for 2009–10. This is the biggest year of tax and tax credit reform measures since Labour came to power. Note that the numbers used here differ from those presented in the Treasury's Budget and Pre-Budget Report tables because, where possible, we have abstracted from reforms that have already been implemented and from those that are not due to be implemented until 2009–10, although this has not been possible for all taxes.

14.3 The impact on effective marginal tax rates

In this section, we analyse the impact of the reforms on the structure of effective marginal tax rates, first abstracting from the reforms to the tax credit system and then including them for an example family with children. We also use this work to highlight some winners and losers in Section 14.4.

Figure 14.1 shows the marginal rate structure for income tax and employees' National Insurance (NI) under the current Autumn 2007 tax system and in the April 2008 tax system with respect to earned income.[3] The reforms announced in Budget 2007 represent a simplification of the marginal rate structure at the bottom: with the 10p starting rate of income tax for non-savings income abolished, there is no longer the 'step up' at the point at which the basic rate currently kicks in (at £7,755 in 2008–09 prices). However, the 10% starting rate remains in place for savings income, and whilst it may be argued that this is to maintain and strengthen incentives for saving, there seems little justification for keeping the starting rate at all, and further simplification by abolishing it would seem a sensible reform.[4]

Further simplification in the structure of income tax and National Insurance is set to occur in 2009–10 with the alignment of the upper earnings limit (UEL) of National Insurance and the higher rate threshold of income tax. This will remove the 'step down' in marginal rates at approximately £40,000 that remains in 2008–09 as the alignment is phased in.

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[2] The implied cost of these reforms using the IFS tax and benefit simulator TAXBEN in Section 14.4 is about £3.2 billion. The figures differ partly due to the timing of receipts (TAXBEN uses a fully accruals-based method). However, the Treasury has more information available for its calculations and, apart from the timing issue, its estimates should be more accurate as a guide to the fiscal impact of the reforms.

[3] To make it comparable to the April 2008 tax and benefit system, the Autumn 2007 tax and benefit system has been indexed using standard uprating procedures.

[4] There exist both theoretical and practical arguments for zero taxation on savings income, although these are contested and subject to much disagreement. However, given that the government does tax savings income, the

Figure 14.1. Income tax and employees' NI: April 2008 vs Autumn 2007

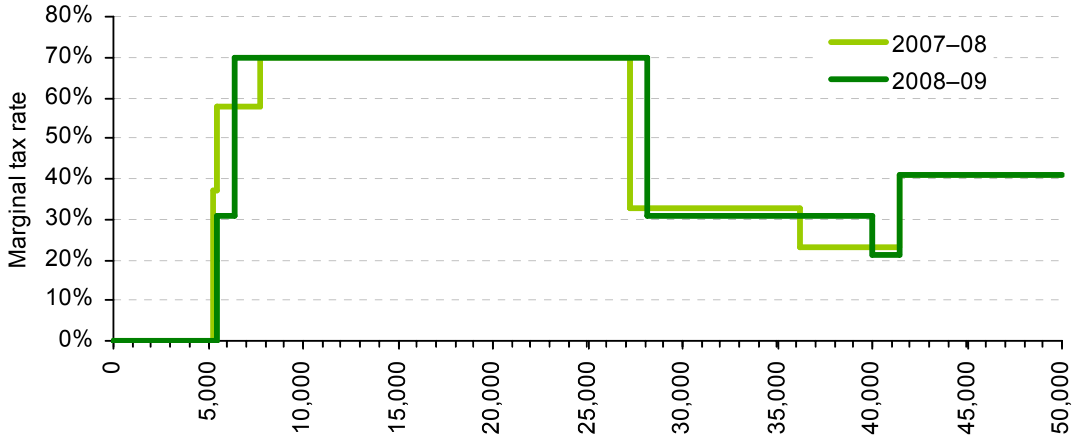
Notes: For simplicity, the marginal rate schedule in the graph abstracts from employers' National Insurance contributions and is based upon a worker contracted into the State Second Pension (S2P). For this individual, gains and losses from the reform are the same after accounting for employers' NI. When accounting for employers' NI, the gains (but not marginal rates) are the same for those contracted out of S2P as for those contracted in, except for those earning between the current UEL and the 2008 UEL: the increase in the UEL increases the amount of earnings that the employer can pay the reduced 'contracted out' rate on and hence gains could be larger than shown in this income range.
Source: Author's calculations.

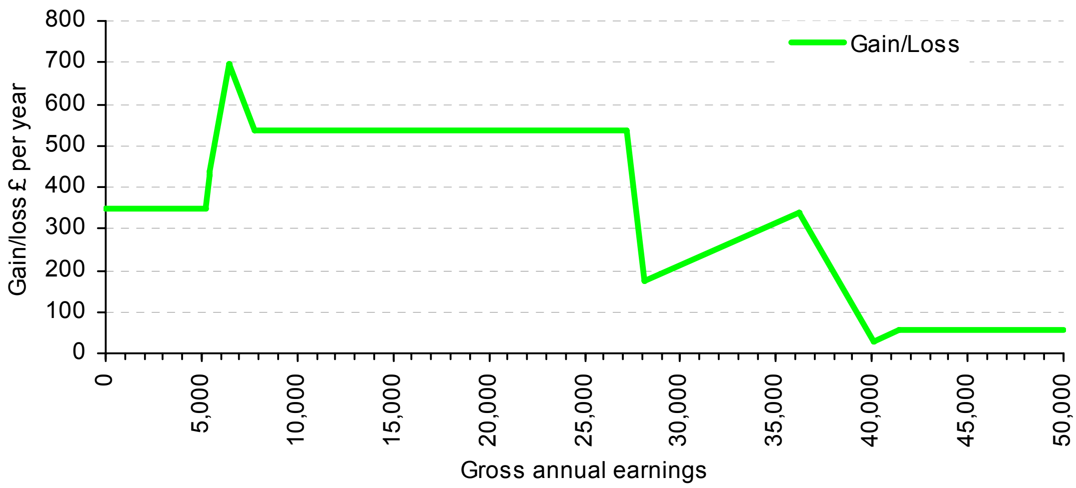
In 2008–09, those earning between £5,435 per annum and approximately £18,500 lose from the reforms to income tax and National Insurance, whilst those earning more than £18,500 all gain, although those earning more than about £39,000 are never better off by more than about £1 per week or £52 per year. Losses are greatest at the current threshold for the basic rate of income tax (with losses of approximately £232 per year) and gains are greatest at the current National Insurance UEL (with gains of approximately £337 per year). In April 2009, when the UEL and higher-rate threshold are aligned at a slightly raised level, those who are still higher-rate taxpayers will see zero effect on their net income, although those earning between

administrative difficulties of keeping the 10% starting rate (including the need for taxpayers to 'claim back' excess tax deducted at source) make abolition of this rate attractive.

approximately £41,500 and £43,300 will see modest declines in net pay (of up to about £1.50 per week or £80 a year).

Figure 14.2. Income tax, tax credit and employees' NI: April 2008 vs Autumn 2007





Notes: As Figure 14.1. This graph is drawn for a one-earner couple, or a lone parent, with two children aged between 1 and 16. Such a couple would not be entitled to the childcare element of the working tax credit; however, a lone parent would be, and we assume that they do not take it up.
Source: Author's calculations.

Figure 14.2 includes the impact of reforms to the tax credit system in addition to those for income tax and National Insurance. It is drawn for an example family – a one-earner family, with two children aged between 1 and 16. Notice that whereas under the Autumn 2007 system the working tax credit threshold and income tax personal allowance were almost aligned (at £5,220 and £5,225 respectively), the £1,200 increase in the working tax credit threshold moves these systems away from alignment. The increase in the child element of the child tax credit is balanced by the increase in the tax credit taper rate (from 37% to 39%) so that the size of the range of incomes that the main tax credit taper rate applies to is more or less the same, although it is somewhat shifted to the right (i.e. towards higher incomes).

Here, gains are highest (at almost £700) at the point at which the working tax credit taper will begin in 2008 – £6,420 per annum. Gains then fall until £7,755 per annum, when the basic rate of income tax currently starts, and then remain constant until the point at which tax credits are currently exhausted for our example family (about £27,000). Gains then fall until the point at which the tax credits are exhausted under the April 2008 system (about £28,000); from this point onwards, the pattern is the same as in Figure 14.1. Hence, for families with children, the biggest gains accrue to low to middle earners who are on the tax credit taper.

A number of further points are worth noting:

- The income tax reforms reduce the marginal tax rate faced by those paying National Insurance and the basic rate of income tax, but the increase in the tax credit taper rate exactly offsets this for the many families who will have their tax credits withdrawn faster. Hence, those facing the highest marginal rates (those on the withdrawal tapers of tax credits and means-tested benefits) see no improvement in their incentive to earn an extra pound.

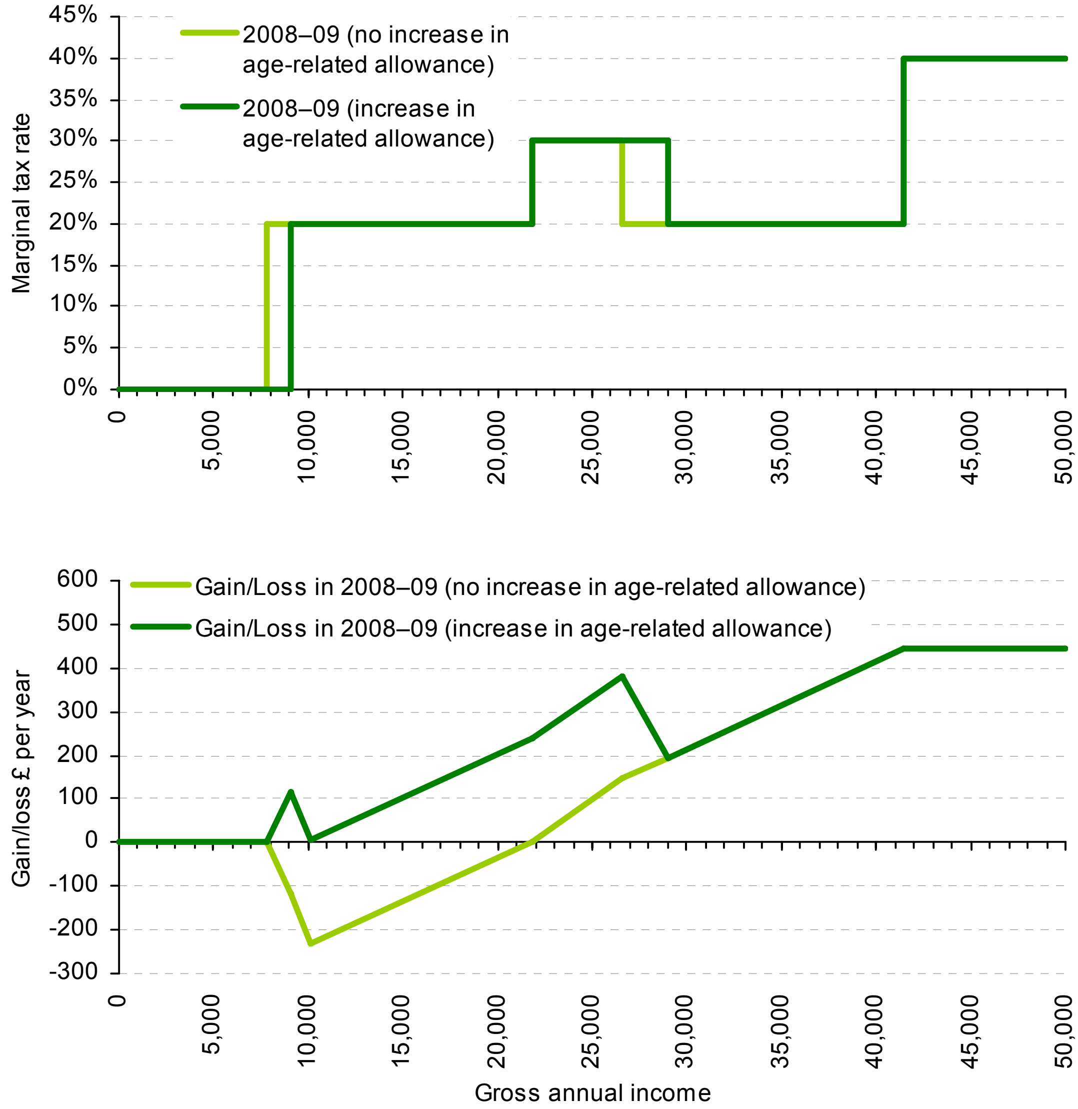
- The increase in the working tax credit threshold is presumably intended to compensate for the abolition of the 10p starting rate (and, combined with the increase in the child tax credit, to make working families with children better off). But some people ‘fall through the net’ and are made worse off: those who do not receive either the working tax credit or the child tax credit but who have incomes between £5,435 and £18,500 per year. This group includes childless single adults aged under 25 and childless adults working less than 30 hours per week (since these groups are not eligible for these tax credits) and those who are entitled but not claiming: only 19% of entitled families without children take up their working tax credit entitlement, for instance.[5]

- The reforms appear to have been carefully structured to ensure that there are no losers amongst those aged 65 or over. The maximum loss that one could face from the abolition of the 10p starting rate is £232 whilst the increase in the age-related allowance for those aged 65–74 is worth £237 under the 20p basic rate of income tax. This means that those who are aged 65 or over are at least £5 per year better off. Figure 14.3 shows the impact of the reforms on a single pensioner aged 65–74. Note that the gains are highest in absolute terms for the richest pensioners, at up to £440 per annum. It is worth bearing in mind that this does not mean there are no pensioner losers; single women aged between 60 and 64 with non-savings income between £5,435 and £18,500 do lose unless they work full-time and are claiming the working tax credit, as they are not entitled to the increased age-related allowances.

- Whilst in 2008–09 higher-rate taxpayers will be a little better off due to the reforms, following the alignment of the NI UEL and the higher-rate income tax threshold in 2009–10 higher-rate payers would have been left worse off by about £75 per year. The £800 increase in the higher-rate threshold just compensates for this, meaning that employed higher-rate payers will find themselves virtually unaffected by the reforms (the self-employed will be a little better off).

[5] Table 10 of HMRC, *Child Tax Credit and Working Tax Credit: Take-Up Rates 2004–05*, 2007 (http://www.hmrc.gov.uk/stats/personal-tax-credits/takeup-rates2004-05.pdf).

Figure 14.3. Income tax for a single pensioner aged 65–74



Notes: Age-related allowances are tapered away at a rate of 50p in the pound when incomes exceed £21,800, hence the higher marginal tax rates between £4,800 and £7,200 above this threshold. The graph is drawn for a single pensioner with no savings income. The line labels suffixed 'no increase in age-related allowance' refer to a system that includes the abolition of the starting rate of income tax but without the increase in age-related personal allowances.
Source: Author's calculations.

Table 14.2 shows how the reforms change the distribution of effective marginal tax rates (EMTRs) (on earned income), with the numbers of taxpayers shown by 10% marginal rate band. The EMTR includes the impact of income tax, employees' and employers' National Insurance (the latter included to ensure consistency),[6] with withdrawal of tax credits and

[6] Taxes on wages (e.g. income tax and employees' and employers' National Insurance contributions) may be partly incident on shareholders or consumers, however public discourse typically assumes the first two are fully incident on employees. Employers' and employees' National Insurance are structurally nearly identical, meaning it is sensible to assume that, at least in the longer term, they have the same incidence; hence the convention used here is to treat them both as incident on workers.

means-tested benefits, but excludes indirect taxation (i.e. VAT). From this table, we can see the following:

- There is an increase of approximately 0.5 million in those with an EMTR of less than 10%; these are people aged 65 or over benefiting from the higher age-related personal allowances and who will no longer pay income tax.
- There is a fall in the number facing an EMTR of between 10% and 20%, and an increase in those facing EMTRs of between 20% and 30%, both due to the abolition of the 10p starting rate on non-savings income.
- There is a very significant increase in the number facing an EMTR of between 30% and 40%, with a large fall in those facing an EMTR of between 40% and 50%. This is due to a fall in the EMTR from approximately 40.6% to 38.8% for those contracted into the State Second Pension and presently paying the 22% basic rate of income tax (which becomes 20% following the reform). Those contracted out of the State Second Pension see a very similar reduction in their effective marginal rate but already pay a rate of less than 40% and so do not move bands.
- Amongst those with higher EMTRs, there is an increase in the number of people facing marginal rates of between 70% and 80%; the shift in the tax credit taper up the income distribution has increased the number of people subject to withdrawal of tax credits as their income rises.

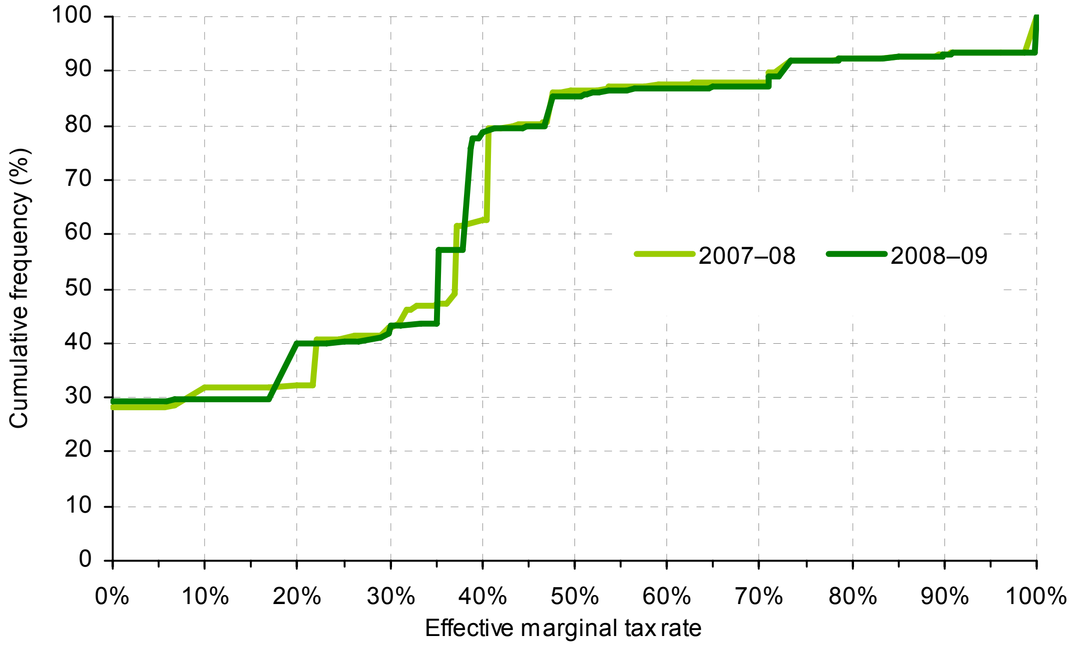
Table 14.2. Numbers of individuals facing different marginal rates

	Autumn 2007 system		April 2008 system		Change	
	Number (thous.)	%	Number (thous.)	%	Number (thous.)	%
0≤EMTR<10	13,174	28.5	13,684	29.6	+510	+1.1
10≤EMTR<20	1,654	3.6	15	0.0	-1,639	–3.6
20≤EMTR<30	4,389	9.5	5,238	11.3	+849	+1.8
30≤EMTR<40	9,287	20.0	17,087	36.9	+7,800	+16.9
40≤EMTR<50	11,515	24.9	3,547	7.7	-7,968	–17.2
50≤EMTR<60	447	1.0	692	1.5	+245	+0.5
60≤EMTR<70	296	0.6	105	0.2	-191	–0.4
70≤EMTR<80	2,009	4.3	2,411	5.2	+402	+0.9
80≤EMTR<90	296	0.6	259	0.6	-37	0.0
90≤EMTR≤100	3,243	7.0	3,273	7.1	+30	+0.1
Overall	46,310	100	46,310	100		

Notes: All adults in private households, including those not currently employed. Includes employers' National Insurance.
Sources: IFS tax and benefit model, TAXBEN, based on 2005–06 Family Resources Survey; author's calculations.

Figure 14.4 gives more detail on the changing distribution of EMTRs by showing a cumulative frequency graph: the height of the graph at each marginal rate shows the percentage of people facing a marginal rate less than or equal to that rate. This emphasises the point that the set of reforms does little to reduce marginal rates for those with very high rates: the distribution above 40% is virtually identical under the Autumn 2007 and April 2008 systems.

Figure 14.4. Distribution of effective marginal tax rates



Notes: All adults in private households, including those not currently employed. Includes employers' National Insurance.
Sources: IFS tax and benefit model, TAXBEN, based on 2005–06 Family Resources Survey; author's calculations.

Despite the significant changes to the distribution of EMTRs, the average (mean) marginal rate will be almost unchanged: it is 31.79% under the current system and will be 31.77% after the reforms due in April 2008. Underlying this aggregate figure, some subgroups of the population see small falls in their average marginal tax rate (generally those without children), whilst others see small rises (generally households with children and more than one adult), but changes are not dramatic, on average, for any group. Around three-quarters of a million people see their EMTR fall by 5 percentage points or more, 18.6 million see it fall by between 1 and 5 percentage points, 22 million see little change and about 5 million see an increase of at least 1 percentage point.

Looking forward, 2009–10 is set to see a rise in the higher-rate threshold of £800 above indexation to a level of £43,385 (assuming inflation of 2.75% in September 2008). This increase reduces the number of higher-rate taxpayers by about 190,000. However, due to fiscal drag in 2007–08 and 2008–09, this remains about 100,000 higher than the number estimated for the tax year 2006–07 (the year immediately preceding the announcement of the these reforms), when the government estimates there were approximately 3.58 million higher-rate taxpayers. Furthermore, it is significantly greater than the 2.1 million higher-rate taxpayers in 1996–97, the year prior to Labour coming to power.[7]

[7] Source: http://www.hmrc.gov.uk/stats/income_tax/table2-1.pdf.

14.4 Winners and losers

In this section, we show the distributional impact of the following reforms, assuming full compliance with the tax rules and full take-up of benefit and tax credit entitlements:

(1) the direct tax changes that take effect in April 2008 (i.e. abolition of the 10p starting rate of income tax on non-savings income, reduction of the basic rate of income tax to 20p, increase in age-related allowances, raising of the National Insurance UEL);

(2) the changes to the working tax credit and child tax credit;

(3) the changes in (1) and (2) considered together;

(4) the changes in (1) and (2) plus the changes to indirect taxation (i.e. increase in fuel duty).

The counterfactual with which we compare each set of reforms is where tax and benefit withdrawal rates remain unchanged from current (2007–08) levels, and tax thresholds, and benefit and tax credit amounts are uprated in line with the public finance defaults.[8] This means we include in our impact the pre-announced decision to uprate the child element of the child tax credit by average earnings, even though this would have taken place without the changes announced in Budget 2007 and Pre-Budget Report 2007. Most of our analysis is done at the level of the household, where each household can contain several families or benefit units. Examples of multiple-benefit-unit (MBU) households include young adult children living with their parents, an elderly person living with their children, and single adults sharing a house. Households with MBUs are more difficult to classify than those containing a single benefit unit, and hence we categorise them separately in the distributional analysis that follows.

Tables 14.3 and 14.4 show the average impact on each tenth of the income distribution as a percentage of disposable income and in cash terms respectively. Tables 14.5 and 14.6 show the average impact on a number of different household types. Table 14.7 shows how many households gain and lose from the reforms to income tax, National Insurance and tax credits only.

Remember that this is not an exhaustive list of the revenue-affecting reforms planned for the year beginning April 2008. Changes in corporation tax, capital gains tax, inheritance tax and business rates will all affect families in a way that may vary across the distribution; unfortunately, it is not possible to model these fully given the data available. However, as shown in Section 14.2, these additional reforms are expected to mean that households, on average, must be less positively affected by the entire package announced during 2007 than by the subset of policies we analyse here.

[8] This typically, but not always, means uprated in line with inflation. For instance, we assume the pension credit guarantee is uprated in line with average earnings and that the family element of the child tax credit is frozen in cash terms.

Table 14.3. Percentage gains from reforms in April 2008

Income decile group	Income tax and National Insurance (1)	Child tax credit and working tax credit (2)	Income tax, NI, child tax credit and working tax credit (1 + 2)	Income tax, NI, child tax credit, working tax credit and fuel duty (1 + 2 + fuel duty)
Poorest	–0.31%	1.40%	1.08%	0.99%
2	–0.31%	1.39%	1.08%	1.02%
3	–0.27%	0.97%	0.70%	0.65%
4	–0.16%	0.45%	0.29%	0.23%
5	–0.10%	0.24%	0.14%	0.08%
6	0.07%	0.11%	0.17%	0.12%
7	0.20%	0.05%	0.25%	0.19%
8	0.43%	0.02%	0.44%	0.39%
9	0.60%	0.01%	0.61%	0.56%
Richest	0.47%	0.00%	0.47%	0.43%
Overall	0.23%	0.24%	0.47%	0.42%

Notes: Income deciles are derived by dividing all households into 10 equally sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth.
Sources: IFS tax and benefit model, TAXBEN, based on 2005–06 Family Resources Survey; author's calculations.

Table 14.4. Weekly cash gains from reforms in April 2008 (2008 prices)

Income decile group	Income tax and National Insurance (1)	Child tax credit and working tax credit (2)	Income tax, NI, child tax credit and working tax credit (1 + 2)	Income tax, NI, child tax credit, working tax credit and fuel duty (1 + 2 + fuel duty)
Poorest	–£0.63	£2.81	£2.16	£1.99
2	–£0.84	£3.80	£2.95	£2.80
3	–£0.85	£3.07	£2.21	£2.03
4	–£0.57	£1.59	£1.01	£0.83
5	–£0.43	£1.02	£0.59	£0.35
6	£0.33	£0.52	£0.86	£0.58
7	£1.14	£0.29	£1.42	£1.08
8	£2.89	£0.13	£3.02	£2.63
9	£4.93	£0.07	£5.00	£4.59
Richest	£6.84	£0.02	£6.87	£6.36
Overall	£1.28	£1.33	£2.61	£2.32

Notes: As for Table 14.3.
Sources: As for Table 14.3.

Tables 14.3 and 14.4 show the following:

- The changes in direct tax (income tax and National Insurance) are regressive: they lead to a slight reduction in disposable income in lower deciles (particularly deciles 1 to 3) and a slight increase for those in decile 6 and above.
- Overall, the changes to National Insurance and income tax have a net cost to the Treasury and lead to an average gain amongst households of £1.28 per week.

- The changes in tax credits are progressive and lead to a noticeable gain in disposable income for deciles 1 to 3 (those most adversely affected by the tax changes), whilst those in the top two deciles see effectively no impact.
- The combined impact of tax reforms that benefit those on higher incomes, and tax credit changes that strongly benefit those on lower incomes, is that the reforms set for 2008–09 have a U-shaped distributional impact, benefiting the top and bottom of the income distribution but leaving those in the middle practically unaffected. Absolute cash gains are greatest at the top of the income distribution.
- The increase in fuel duty results in a reduction in disposable income for all deciles but is relatively neutral across the deciles in its distributional impact.
- It should be borne in mind that the average gain to households of 0.42% of their disposable income from the combined package of personal tax, tax credit and fuel duty reforms represents the effect of only a subset of the total set of tax changes to be introduced in April. It does not include the effect of measures that we cannot attribute to specific households (most notably the changes to corporation tax, business rates, capital gains tax and inheritance tax). Together, the full package has an aggregate cost to the Treasury of £470 million in the 2008–09 tax year. Taking this into account means that the average household will be approximately 35p better off per week (rather than £2.32), which is equivalent to 0.06% of their post-tax income (rather than 0.42%).

Tables 14.5 and 14.6 show the following:

- The changes to the direct tax system make non-working couples with children worse off, on average. Most non-workers pay no income tax, but a number have taxable benefit (e.g. incapacity benefit) and other unearned income, which means they do pay some income tax. These have lost out due to the abolition of the 10p starting rate for non-savings income. Employed lone parents typically have low earnings and hence are similarly affected.
- All employed family types, except lone parents, benefit from the changes in direct tax, on average. Pensioners gain the most proportionally from the changes due to the higher age-related tax allowances and the fact that they do not pay employees' National Insurance (which has increased for those with employment income of more than about £36,000).
- The changes in the tax credits leave no family type worse off, on average. Gains are very much concentrated amongst families with children, particularly lone parents and couples with children where at least one parent is not in paid work.
- On average, all household types are better off from the full combination of reforms that we can attribute to specific households. The largest gainers in percentage terms are lone parents and non-working couples with children. In absolute terms, the largest gainers are lone parents and couples with children where at least one parent is not in paid work.

Table 14.5. Percentage gains from reforms in April 2008, by family type

	Income tax and National Insurance	Child tax credit and working tax credit	IT, NI, CTC and WTC	IT, NI, CTC, WTC and fuel duty
Single, not working	0.02%	0.00%	0.02%	–0.08%
Single, employed	0.31%	0.06%	0.37%	0.30%
Single parent, not working	0.00%	2.25%	2.26%	2.19%
Single parent, working	–0.06%	1.87%	1.81%	1.75%
0-earner couple w/o kids	0.06%	0.00%	0.06%	0.00%
0-earner couple with kids	–0.20%	1.91%	1.70%	1.66%
1-earner couple w/o kids	0.28%	0.06%	0.34%	0.29%
1-earner couple with kids	0.23%	0.84%	1.07%	1.03%
2-earner couple w/o kids	0.29%	0.01%	0.30%	0.25%
2-earner couple with kids	0.21%	0.21%	0.42%	0.39%
Single pensioner	0.50%	0.00%	0.50%	0.41%
Couple pensioner	0.61%	0.00%	0.62%	0.56%
MBU w/o kids	0.05%	0.07%	0.12%	0.08%
MBU with kids	–0.07%	0.60%	0.53%	0.50%
Overall	0.23%	0.24%	0.47%	0.42%

Notes: Households are defined as the type of benefit unit living in that household except where there is more than one benefit unit resident, in which case it is classified as a multiple-benefit-unit (MBU) household. Single-benefit-unit (SBU) households are classified as pensioners if either adult is a pensioner (male: aged 65 or over; female: aged 60 or over). Some pensioner households also contain children; some pensioners can be found in MBU households; and some male claimants of the pension credit guarantee can be found in other SBU household types (since this can be received by single men aged 60 to 64 who are not pensioners).
Sources: IFS tax and benefit model, TAXBEN, based on 2005–06 Family Resources Survey; author's calculations.

Table 14.6. Weekly cash gains from reforms in April 2008, by family type (2008 prices)

	Income tax and National Insurance	Child tax credit and working tax credit	IT, NI, CTC and WTC	IT, NI, CTC, WTC and fuel duty
Single, not working	£0.04	£0.00	£0.04	–£0.16
Single, employed	£1.50	£0.31	£1.80	£1.46
Single parent, not working	£0.01	£6.27	£6.28	£6.10
Single parent, working	–£0.23	£7.44	£7.19	£6.95
0-earner couple w/o kids	£0.26	£0.00	£0.26	£0.02
0-earner couple with kids	–£0.76	£7.16	£6.40	£6.22
1-earner couple w/o kids	£1.68	£0.39	£2.07	£1.76
1-earner couple with kids	£1.43	£5.33	£6.75	£6.50
2-earner couple w/o kids	£2.28	£0.11	£2.39	£2.01
2-earner couple with kids	£1.69	£1.71	£3.40	£3.09
Single pensioner	£1.33	£0.00	£1.34	£1.09
Couple pensioner	£2.89	£0.02	£2.92	£2.65
MBU w/o kids	£0.40	£0.49	£0.89	£0.59
MBU with kids	–£0.54	£4.63	£4.09	£3.85
Overall	£1.28	£1.33	£2.61	£2.32

Notes: As for Table 14.5.
Source: As for Table 14.5.

Table 14.7. Winners and losers from income tax, National Insurance and tax credit reforms

	Income tax, NI & tax credits (thousands of households)	Income tax & NI (thousands of households)
Single, no children		
losing £1 to £9.99	538	667
staying within +/– £1	1,854	1,852
gaining £1 to £9.99	1,455	1,329
gaining > £10 a week	12	12
Single, children		
losing £1 to £9.99	0	332
staying within +/– £1	21	988
gaining £1 to £9.99	1,088	184
gaining > £10 a week	395	1
Couple, no children		
losing £1 to £9.99	1,153	1,263
staying within +/– £1	997	1,021
gaining £1 to £9.99	2,323	2,189
gaining > £10 a week	209	209
Couple, children		
losing £1 to £9.99	444	1,125
staying within +/– £1	625	1,235
gaining £1 to £9.99	2,754	2,049
gaining > £10 a week	670	84
Pensioners		
losing £1 to £9.99	275	278
staying within +/– £1	3,360	3,367
gaining £1 to £9.99	2,557	2,548
gaining > £10 a week	201	199
MBU, no children		
losing > £10	23	35
losing £1 to £9.99	983	1,144
staying within +/– £1	967	961
gaining £1 to £9.99	1,173	1,021
gaining > £10 a week	141	125
MBU, children		
losing >£10	1	10
losing £1 to £9.99	193	572
staying within +/– £1	138	333
gaining £1 to £9.99	772	326
gaining > £10 a week	161	23
Total		
losing > £10 a week	24	46
losing £1 to £9.99	3,585	5,379
staying within +/– £1	7,963	9,759
gaining £1 to £9.99	12,121	9,647
gaining > £10 a week	1,788	653

Sources: IFS tax and benefit model, TAXBEN, based on 2005–06 Family Resources Survey; author's calculations.

Table 14.7 shows the numbers of winners and losers from the reforms to income tax, National Insurance and tax credits (i.e. it excludes the impact of the rise in fuel duty). It shows that the number of winners from these changes considerably outweighs the number of losers: about 14% of households lose more than £1 per week, 55% gain at least £1 per week and the remaining 31% see little change. Furthermore, the table shows the following:

- Very few households with children lose from the entire package taken together (about 9%, including virtually no lone-parent families), but about 28% would have been losers without the reforms to child tax credit and the working tax credit. Hence, the reforms to the tax credit system are important in reducing the number of families with children that lose from the reform package.
- The reform of the working tax credit does less to compensate the losers from the tax reforms amongst (non-pensioner) families without children: 23% lose out as opposed to the 26% that would have lost without the increased working tax credit threshold.
- Large gains (of greater than £10 per week) are most common for families with children.
- Some pensioner households lose out from the reform (those where there is an income-tax-paying woman aged 60 to 64) but the vast majority are better off or unaffected. The tax credit reforms make little difference to this group as few have children or are in paid work.[9]

14.5 The impact of tax and benefit changes since 1997

In this section, we look at the impact of all the tax and benefit changes that have taken place since Labour came to power in 1997 (including the impact of increased council tax) and see how the full effect of the reforms announced in Budget 2007 and Pre-Budget Report 2007 and due to be implemented in April 2008 changes the picture.

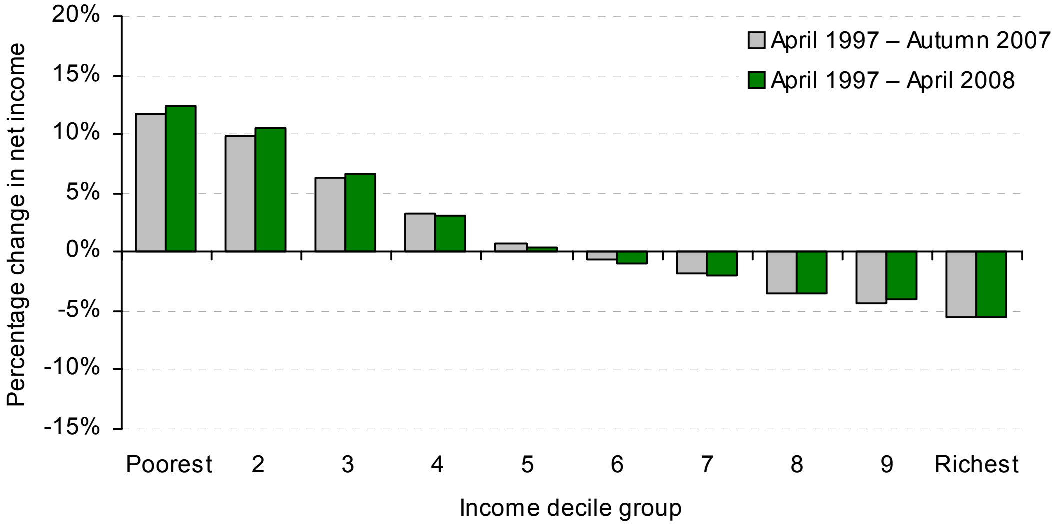
Over the past 11 years, there have been many important changes to the tax system that we are unable to model explicitly but that we should account for given the significant amounts raised or given away. Full details of our methodology for dealing with this can be found in the Notes to Figure 14.5, but the crux of the matter is this: we assume that the residual change in tax take after accounting for what we can model is shared proportionally across income deciles and household types.[10] This assumes that unmodelled tax changes (e.g. changes in corporation tax, inheritance tax and capital gains tax) affect each group proportional to their income and so are neutral in distributional terms. This is unlikely to be strictly true, but it represents the simplest and most conservative arbitrary apportionment possible.[11]

[9] See the Notes to Table 14.3.

[10] We do not use this assumption in Section 14.4, where we focus purely on those reforms we can model.

[11] Alternative approaches would require other *arbitrary* distributional assumptions that require a ‘story’ of the incidence of other taxes – e.g. corporation tax may lead to lower returns on capital, lower returns for labour or higher prices (affecting both returns).

Figure 14.5. Impact of reforms to date on distribution of income



Notes: We are able to model most of the changes to the benefit system, income tax, National Insurance, tax credits and council tax (using the Family Resources Survey 2005), along with VAT and most excise duties (using the Expenditure and Food Survey 2005) and stamp duty land tax payable on residential property (using the British Household Panel Survey 2006). Other tax changes are not modelled explicitly but amount to a tax rise of roughly £18 billion under the Autumn 2007 system and £21 billion under the April 2008 system. This means the figures here include a reduction in net income of 2.45% for all deciles and household types under the Autumn 2007 system and of 2.83% under the April 2008 system.

The population deciles used here are based on the Autumn 2007 tax and benefit system. Hence the first column is the impact on net income of the reforms since 1997 on those estimated to have the lowest incomes under the current system rather than those estimated to have the lowest incomes under the April 1997 tax and benefit system. If we believe the reforms undertaken were progressive but benefited some groups of people more than others, this would tend to make the set of reforms look less progressive than it actually was – because some of those with lower incomes in 1997 have been pushed up into higher income deciles, and some of those initially with middle incomes have been pushed down into lower deciles. This methodology is, however, the easiest to interpret particularly when comparing the Autumn 2007 and April 2008 tax and benefit systems. Percentage gains and losses are calculated as gains/losses as a proportion of net income under the Autumn 2007 tax system.

Sources: IFS tax and benefit model, TAXBEN, based on 2005–06 Family Resources Survey; author’s calculations.

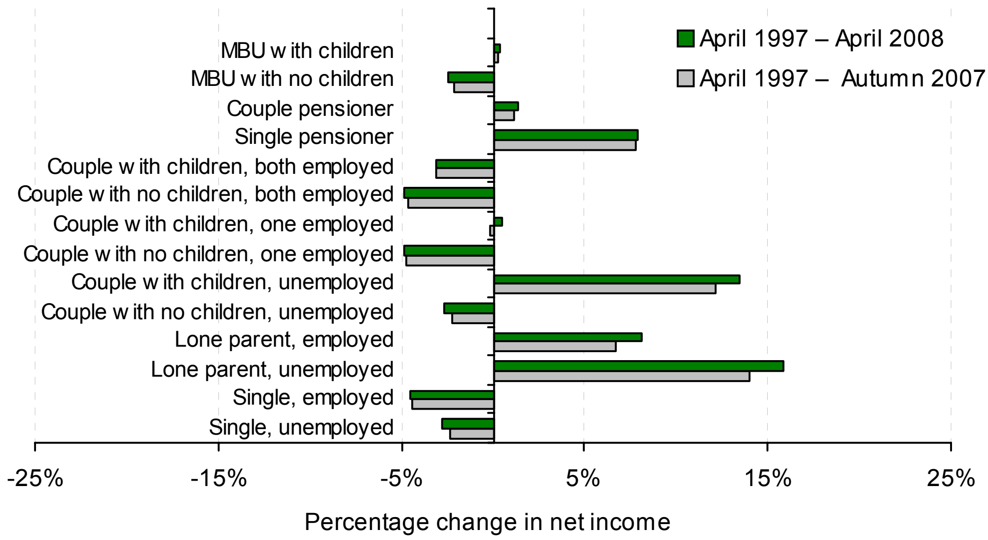
Figure 14.5 shows first the impact across the income distribution of Labour’s reforms up to Autumn 2007 and then the impact including reforms made in April 2008. It shows the following:

- Under both the Autumn 2007 and April 2008 systems, gains are proportionally largest for those in the lowest decile (and in the second in absolute terms), at up to about 12% of net income. They decline with each decile as income rises, and those in deciles 6 and above see losses of up to 5.6% of net income.
- On average, Labour’s tax and benefit reforms have cost households approximately £6.93 a week, comparing the Autumn 2007 system with that which Labour inherited. As a result of the modest net giveaway to be implemented in April, this cumulative cost will fall to £6.64 per household per week under the April 2008 system. This tax increase has been used to finance the increase in spending on public services (particularly health and education) and reductions in government borrowing that have occurred under Labour.

- The changes taking place in April 2008 do little to change the overall picture. Those in deciles 1 to 3 and 8 to 10 see a small improvement, on average, whilst those in deciles 4 to 7 a small loss, on average.[12]

- It should be borne in mind that disposable income has been rising in real terms in every decile under Labour, as we would expect given the fact that the economy grows in real terms over time. In 2005–06, real-terms disposable incomes were 19% higher on average than in 1997–98 with, for instance, an increase of 20.2% at the 95th percentile (i.e. the middle of the top decile), despite the fact that Labour's tax and benefit reforms have in themselves reduced disposable incomes for this group.[13]

Figure 14.6. Impact of reforms to date on different households



Notes: As Figure 14.5.
Sources: As Figure 14.5.

Figure 14.6 demonstrates the same analysis for different household types. It shows the following:

- Pensioners and low-income households with children are the big gainers from the changes in the tax and benefit system over the last 11 years, with the latter being the group that benefits most from the reforms taking place in April 2008. Non-working lone parents gain on average about 15% of net income, whilst non-working couples with children gain about 13%, relative to the April 1997 tax and benefit system.

- In contrast, working-age households without children with no-one in paid work are, on average, worse off following the complete set of tax and benefit reforms of the last 11 years. This emphasises that the strongly redistributionist changes introduced by Labour are also targeted almost solely upon lower-income households containing children or pensioners.

[12] Assuming that those taxes that we do not model explicitly are distributionally neutral.

[13] Source: Households Below Average Income data-sets, courtesy of the Department for Work and Pensions.

- Working households without children have lost, on average, an amount equal to about 5% of net income following the complete set of tax and benefit changes of the last 11 years, and they represent the main net contributors to the tax and benefit reforms of the Labour government. However, despite this, they were, on average, 15% better off in 2005–06 than in 1997–98, the year of Labour's election, because of the economy growing in real terms over time.
- Again, the latest reforms do not drastically change this picture, although they reinforce the strong redistribution to non-working families with children and single parents.

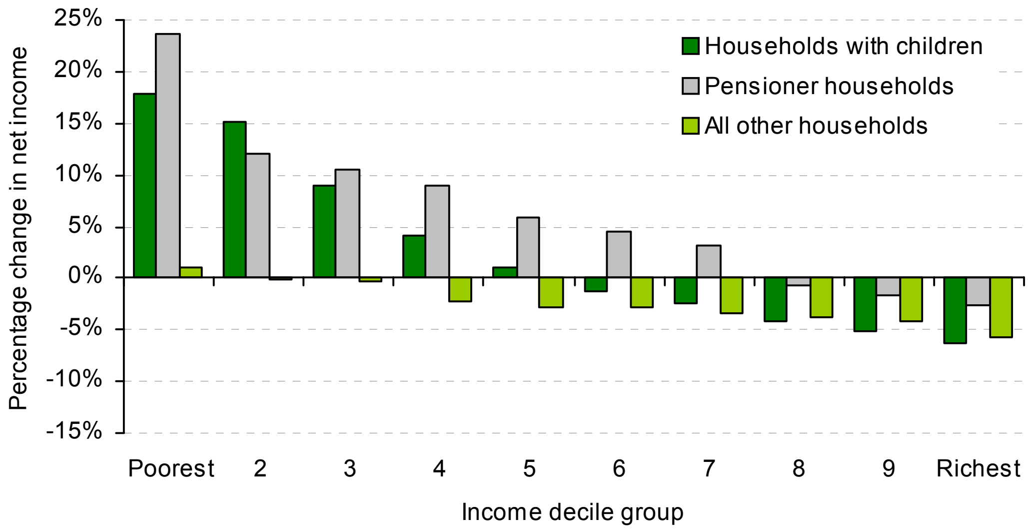
It is also worth asking the following question: 'how many people have seen their incomes change (due to tax and benefit changes) to such an extent that they are now in a different income decile?'. Table 14.8 shows the movements between deciles, with a focus on those in the bottom half of the distribution; movement was less marked further up the distribution, particularly amongst those at the very top.

Table 14.8. The changing income distribution (thousands of households)

Decile in 1997	Decile in 2008					
	Poorest	**2**	**3**	**4**	**5**	**6 or above**
Poorest	2,002	526	16	2	2	1
2	539	1,324	603	73	9	2
3	8	686	1,191	587	70	6
4	0	11	730	1,317	413	77
5	0	1	9	559	1,618	361
6 or above	0	0	0	10	436	12,295

Note: Overall, as many people must move down as up, since each decile remains 10% of the population.
Source: IFS tax and benefit model, TAXBEN, based on 2005–06 Family Resources Survey.

Figure 14.7. Impact of reforms to date on distribution of income, by family type



Notes: As Figure 14.5. 'All other households' include working-age singles and couples without children and households containing multiple benefit units (MBUs) where no benefit units contain children.
Sources: As Figure 14.5.

Movement between deciles has been greatest for deciles 2 to 4, with those originally in the lowest two deciles seeing, on average, moves up the income distribution, whereas those in deciles 3 to 5 have been somewhat more likely to see their relative position fall. Underlying this is the targeting of Labour's redistributive efforts to lower-income families with children and to pensioners. These groups have thus seen an improvement in their relative position (particularly the lowest-income families in these groups), at the expense of other households (particularly single working-age adults). Figure 14.7 shows the impact of the reforms in the period 1997 to 2008 by income decile, separately for families with children, pensioners and all other households. It shows the following:

- Pensioners are, perhaps, the main beneficiaries of the reforms of the last 11 years, with the incomes of the poorest having increased by nearly 24% and sizeable gains far up the income distribution.
- Low-income families with children are also major beneficiaries, with gains equivalent to almost 18% for the poorest tenth. However, as income rises, gains decline quite quickly and, as with the population as a whole in Figure 14.5, for deciles 6 and above there are net losses.
- Of the remaining households (mostly working-age households without children), only the poorest see net gains and these are, on average, equivalent to only 1% of net income. Those in deciles 2 and above are net losers from the tax and benefit changes since 1997.

14.6 Conclusions

So how should we view the set of reforms to the tax and benefit system due in April 2008?

- When combined with further reforms due in 2009–10, they represent an important simplification of the marginal rate structure and could form the basis of further integration of income tax and National Insurance. Keeping the starting rate for savings income seems to have only a tenuous justification, and abolition of this (perhaps with a rise in the personal allowance to ensure revenue neutrality) would be a sensible reform. Furthermore, the increase in the working tax credit threshold has moved the income tax and tax credit systems away from alignment.
- A significant proportion of the population will see their marginal tax rates fall, but those facing the highest marginal rates, and thus the weakest work incentives, will not. Indeed, the numbers facing such high rates are likely to increase somewhat as more people are brought into the reach of the tax credit system. The reforms evidently reflect a desire for tax simplification rather than a desire to strengthen work incentives, which the government would claim to have tackled in other ways.
- The reforms benefit most those at the top and bottom of the distribution – but not by much. Within this group, there are some particular gainers: low-income working families with children; those households with adults who earn between £18,500 and £40,000; and people aged 65 and over with incomes in excess of £7,850. Losers are mainly concentrated amongst those ineligible for the working tax credit (e.g. the young, second

earners, non-working women aged 60 to 64) and those failing to claim their entitlement to tax credits.

- The reforms due in April 2008 have not materially changed the overall distributional impact of the Labour Government since 1997. Labour's tax and benefit reforms have been strongly progressive, and furthermore have focused resources on two particular groups – lower-income families with children, and pensioners. The gains for the former are generally acknowledged in public discourse, but the large gains for pensioners are less well appreciated. A focus on rises in council tax and the basic state pension (which has grown only modestly) means that the gains to this group (mainly through means-tested support) are sometimes forgotten. Labour's generosity to its favoured groups has been paid for by working-age households without children, especially the majority that are employed.