

## FISCAL REFORMS SINCE MAY 1997

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Published by  
The Institute for Fiscal Studies  
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ISBN 1-903274-15-X

Published online at <http://www.ifs.org.uk>

# **Fiscal Reforms Since May 1997**

by

**Michal Myck**

**Institute for Fiscal Studies, 2000**

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# 1. Introduction

Since the May 1997 general election, the Labour government has announced numerous reforms to the structure of the tax and benefit system in the UK. Using the IFS tax and benefit model (TAXBEN), we assess the distributional impact of the reforms that can be directly assigned to individual households. We also provide details of the changes to National Insurance, income tax and indirect taxes as well as government spending with a direct effect on household incomes. More detailed distributional results are laid out in Section 6.

**Table 1.1. Estimated annual budget effect of major fiscal reforms affecting households**

	Positive budget effect	Negative budget effect	
<b>Income tax</b>	Married couple's allowance	£3,120m	
	Company car fuel scales	£375m	
	Income tax rates and personal allowances		-£5,080m
	Working families' tax credit (includes increases in income support child allowances in 2000)		-£3,345m
	Children's tax credit		-£2,180m
	<b>Sub-total</b>	<b>£3,495m</b>	<b>-£10,605m</b>
<b>National Insurance</b>	Employee contributions	£660m	-£3,300m
	Self-employed contributions (net effect of reforms)	£250m	
	<b>Sub-total</b>	<b>£910m</b>	<b>-£3,300m</b>
<b>Indirect taxes</b>	VAT on domestic fuel		-£510m
	Tobacco taxation	£1,740m	
	Road fuel duties	£4,710m	
	Alcohol taxation		-£40m
	Insurance premium tax	£300m	
	<b>Sub-total</b>	<b>£6,750m</b>	<b>-£550m</b>
<b>Spending</b>	Mortgage tax relief	£3,150m	
	Child benefit and income support child premiums		-£2,025m
	Abolition of lone-parent premiums and lower income support child premiums for 18-year-olds	£390m	
	Increase in earnings disregard for income-related benefits to £20		-£20m
	Increases in minimum income guarantee (allowances and capital limits)		-£745m
	Winter allowance for pensioners		-£1,070m
	<b>Sub-total</b>	<b>£3,540m</b>	<b>-£3,860m</b>
	<b>Total</b>	<b>£14,695m</b>	<b>-£18,315m</b>

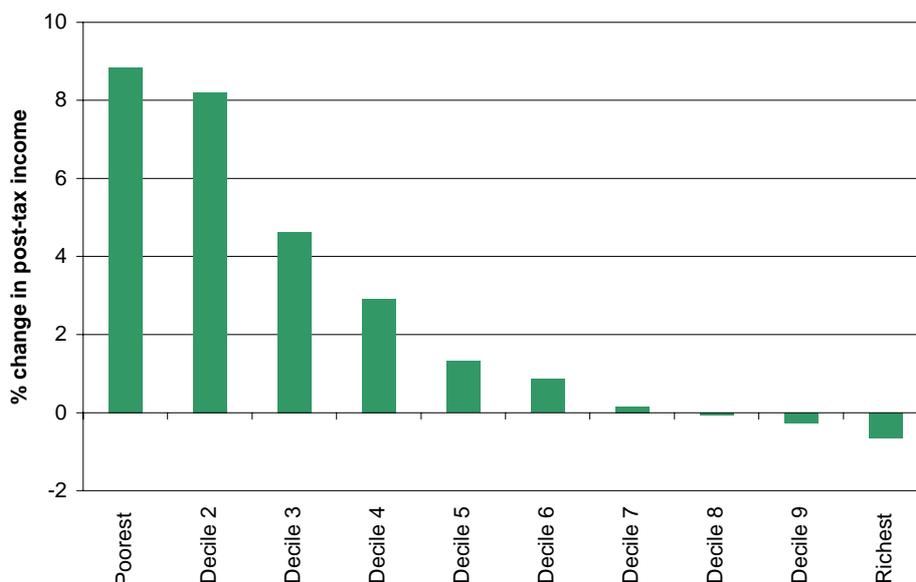
## Summary of changes included in the analysis

The reforms modelled here amount to an absolute change of £33,010m p.a., while their net cost to the government is £3,620m p.a. Table 1.1 shows the budgetary effects of the modelled changes. The absolute change of £33,010m constitutes 53% of the total absolute structural change in the public finances since May 1997. The other 47% of structural change cannot be modelled here as it only indirectly affects household incomes. The unmodelled elements include changes in corporate taxation, employer National Insurance contributions and stamp duties and the introduction of the climate change levy. These unmodelled changes increase government revenue, but the increases cannot be assigned to individual households and so cannot be included in the distributional analysis presented here. While the modelled changes on average lower government revenue, the total net structural change in the public finances will increase government revenue by over £3bn p.a. from 2002–03.

## Overall results

The total distributional effect of the modelled reform package is shown in Figure 1.1. On average, the package benefits households in most deciles. The results reflect the government's commitment to raising the living standards of the lowest-income households. The post-tax income of an average household in the bottom decile of the income distribution is 8.8% higher if we take account of all measures announced since May 1997. Further deciles gain proportionately less on average and the richest 30% of households experience a fall in post-tax income once all of the reforms are considered.

**Figure 1.1. Distributional impact of major fiscal reforms announced since July 1997, by decile**



The gains going to the poorest households are mainly due to the increases in benefit levels for those out of work and to the introduction of the working families' tax credit for those in work.

The loss of income by households in the top decile is associated with increased National Insurance and the abolition of both mortgage tax relief and the married couple's allowance.

**Table 1.2. Changes in post-tax incomes within deciles**

	Percentage of households within a given decile whose income changes by:					Total
	–£10 or more	–£9.99 to –£1	–£0.99 to £1	£1.01 to £10	Over £10	
Poorest	2.9%	23.3%	16.0%	27.0%	30.8%	100.0%
Decile 2	2.0%	17.3%	12.1%	32.1%	36.5%	100.0%
Decile 3	2.9%	16.2%	9.6%	45.2%	26.2%	100.0%
Decile 4	3.2%	18.1%	7.9%	52.3%	18.5%	100.0%
Decile 5	4.4%	24.2%	10.6%	46.7%	14.2%	100.0%
Decile 6	5.0%	23.3%	9.7%	51.5%	10.6%	100.0%
Decile 7	8.7%	29.2%	10.1%	44.3%	7.7%	100.0%
Decile 8	8.2%	34.6%	8.9%	42.9%	5.5%	100.0%
Decile 9	12.3%	36.9%	8.5%	38.7%	3.6%	100.0%
Richest	20.1%	49.3%	8.6%	20.4%	1.7%	100.0%

Table 1.2 presents a decomposition of the average decile effects for the overall impact of the reform package. Within each decile group, we distinguish between households gaining or losing certain amounts of their income. Even within the poorest households, about 3% lose £10 or more as a result of the introduced reforms. Equally, although the richest households on average lose 0.7% of their income, 1.7% of these households gain £10 or more as a consequence of the changes.

**Figure 1.2. Distributional impact of major fiscal reforms announced since July 1997, by family type**

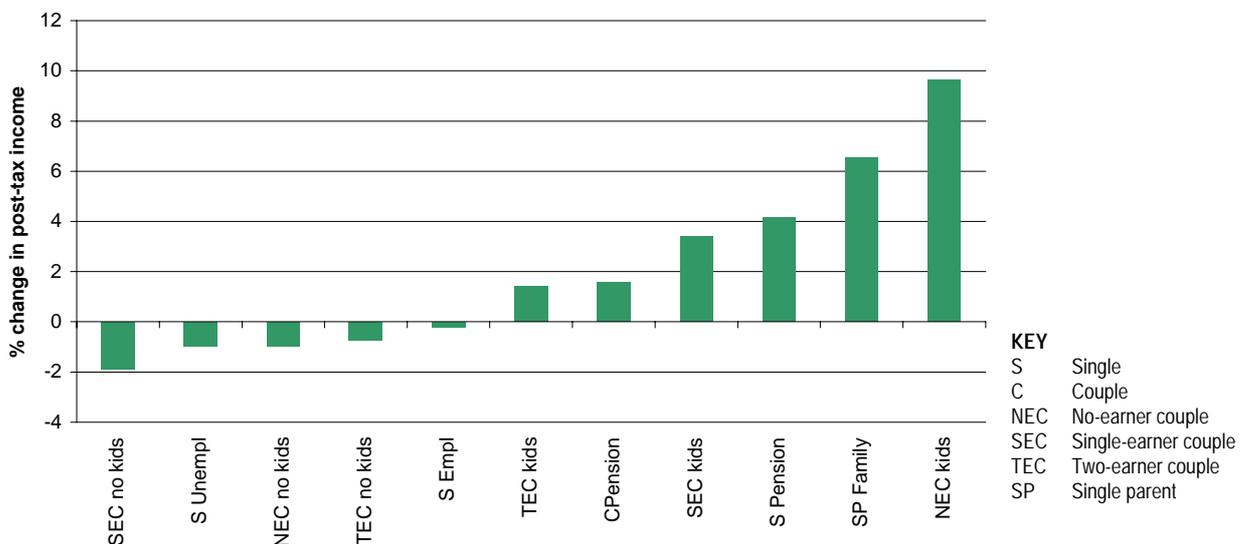


Figure 1.2 shows the results broken down by family type. All types of families with children gain on average from the reforms. This largely reflects the impact of the introduction of the working families' tax credit, the children's tax credit and increases in child benefit and income support child allowances. Two-earner couples with children gain less than other types of families with children as they are least likely to benefit from the working families' tax credit and income

support allowances, and are most likely to see the children's tax credit withdrawn. No-earner couples with children gain most, both relative to their total post-tax income and in absolute terms — an average gain for this type of family is £18.70 per week.

Both single and married pensioners are also net gainers on average. This result is driven mainly by the policies aimed specifically at pensioner households (increased age-related income tax personal allowance, increased income support premiums, winter allowance and retention of the married couple's allowance for those born before 6 April 1935). On average, a single pensioner household has gained £6.10 and a pensioner couple £4.20 per week.

Non-pensioner households without children turn out to lose on average from the reforms. Withdrawal of the married couple's allowance and changes in excise duties are the largest elements driving these effects, and reforms to National Insurance and direct tax rates, which benefit most earners, are insufficient to outweigh the negative effects.

## 2. Income Tax

Most important reforms to the income tax structure during the current Parliament were announced in the Budgets of 1998 and 1999. In 1998, the working families' tax credit was announced to replace family credit from October 1999, while the 1999 Budget brought the introduction of the 10% income tax rate and announced the introduction of a lower, 22%, basic

**Table 2.1. Income tax reforms announced since July 1997**

Announced	Reform	To take effect from:	Estimated annual budget effect in 2001–02 (indexed)
<b>Budget 1998</b>	Company car fuel scales increased	April 1998	£375m
	Working families' tax credit	October 1999	–£1,300m
	Married couple's allowance: relief cut from 15% to 10%; 65s and over compensated	April 1999	£1,120m
<b>Budget 1999</b>	New 10% rate	April 1999	–£1,800m
	Personal allowances for older people increased	April 1999	–£100m
	Working families' tax credit and disabled person's tax credit increased	October 1999	–£750m
	Married couple's allowance abolished for those born after 5 April 1935	April 2000	£2,000m
	Basic rate reduced to 22%	April 2000	–£3,000m
<b>Budget 2000</b>	Children's tax credit	April 2001	–£2,050m
	Starting rate of income tax extended to savings income	April 2000	–£180m
	Under-16 child credit for working families' tax credit and income-related benefits increased by £4.35 from June and October 2000 respectively	June/October 2000	–£1,295m
	Children's tax credit increased from £416 to £442	April 2001	–£130m

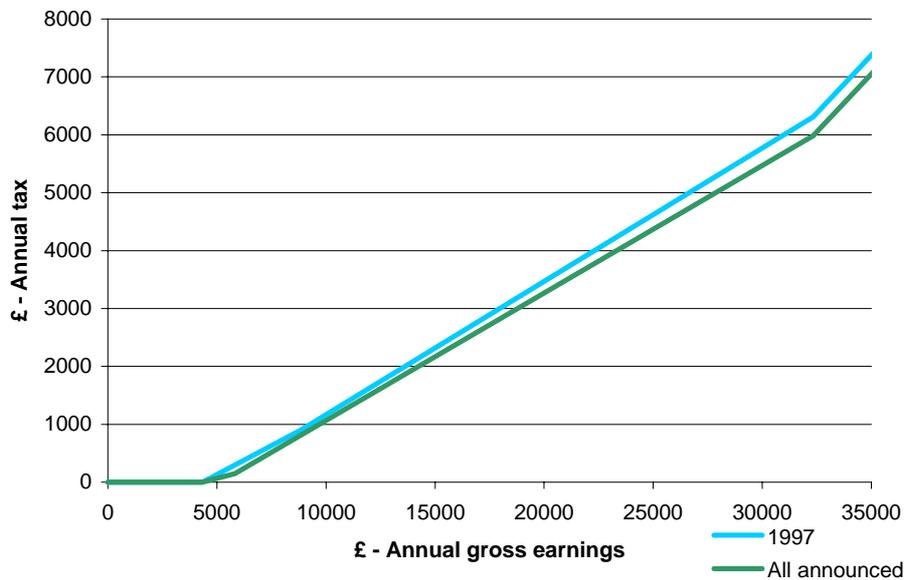
Sources: HM Treasury, *Financial Statement and Budget Report*, various years.

rate and the replacement of the married couple's allowance with children's tax credit. Table 2.1 gives a summary of the most important reforms introduced by the Labour government since 1997 and the annual effects they had or are expected to have on the budget.

### New marginal rates

The new 10% marginal tax rate was introduced in April 1999 to be payable on the first £1,500 of taxable income. The lower 20% rate paid on the first £4,500 of taxable income has been abolished.<sup>1</sup> Together with the reduction in the basic rate in April 2000, changes in the marginal rate structure will make a single earner on income above the higher tax rate band £755 p.a. better off. Budget constraints under the 1997 and the 2000 marginal tax structures (all measures announced) for a single earner without dependent children are plotted in Figures 2.1 and 2.2.

**Figure 2.1. Income tax payable by a single person under the 1997 system and under all measures announced in 1997–2000 Budgets (1999 prices)**



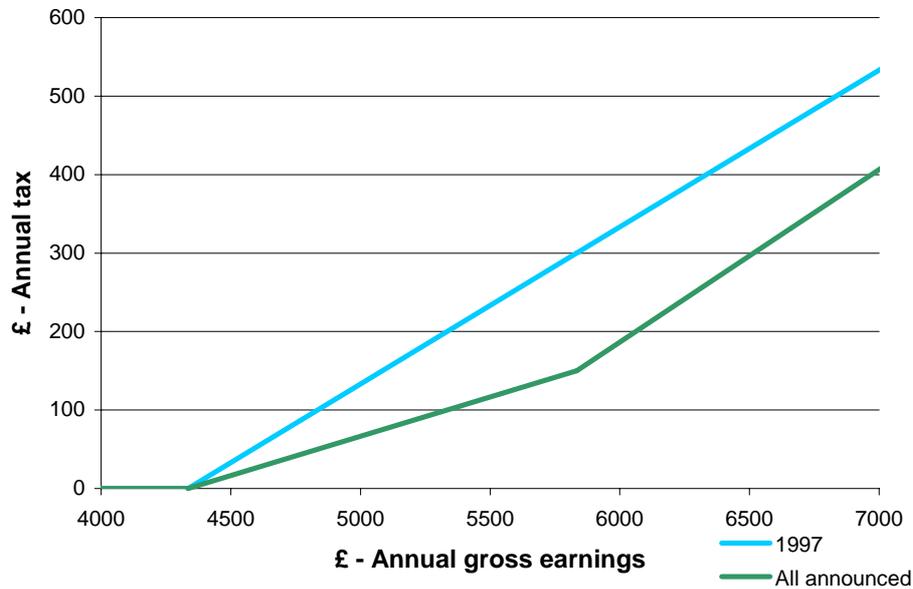
Note: Assuming no deductions for pension contributions and no income other than earnings.

### Married couple's allowance

The married couple's allowance (MCA) for non-pensioners was restricted from 15% to 10% as of April 1999 and the government abolished the allowance from April 2000. As a consequence of that, the budget constraint of a married earner without children will be the same as that of a single person without dependent children (see Figures 2.1 and 2.2). Pensioners' MCA remained largely unaffected by the restriction of the allowance in 1999 as the age-related MCA has been increased so as to compensate for it in full. However, these changes have had an impact on the marginal tax schedule of married pensioners, as shown in Figure 2.3.

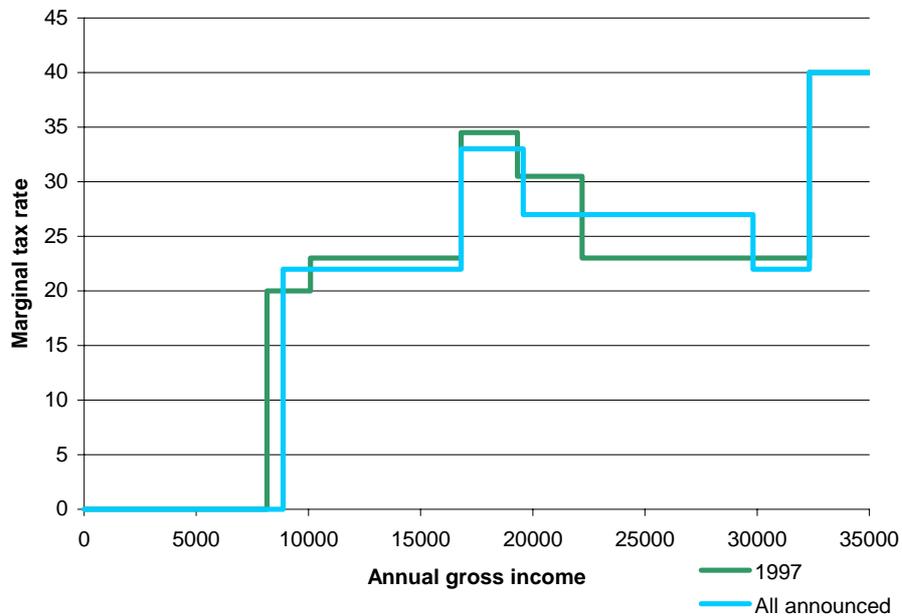
<sup>1</sup> For a discussion of the introduction of the 10% rate, see L. Chennells and A. Dilnot (eds), *The IFS Green Budget: January 1999*, Commentary 76, Institute for Fiscal Studies, London, 1999.

**Figure 2.2. Detail of income tax payable by a single person under the 1997 system and under all measures announced in 1997–2000 Budgets (1999 prices)**



Note: Assuming no deductions for pension contributions and no income other than earnings.

**Figure 2.3. Marginal income tax rates payable by a married pensioner under the 1997 system and under all measures announced in 1997–2000 Budgets (1999 prices)**



Although the MCA for those aged over 65 was not abolished in April 2000 and restriction of it will stay at 10%, abolition of the allowance for those under 65 is going to have an impact on pensioners' budgets. The pensioners' MCA is currently withdrawn down to the level of the

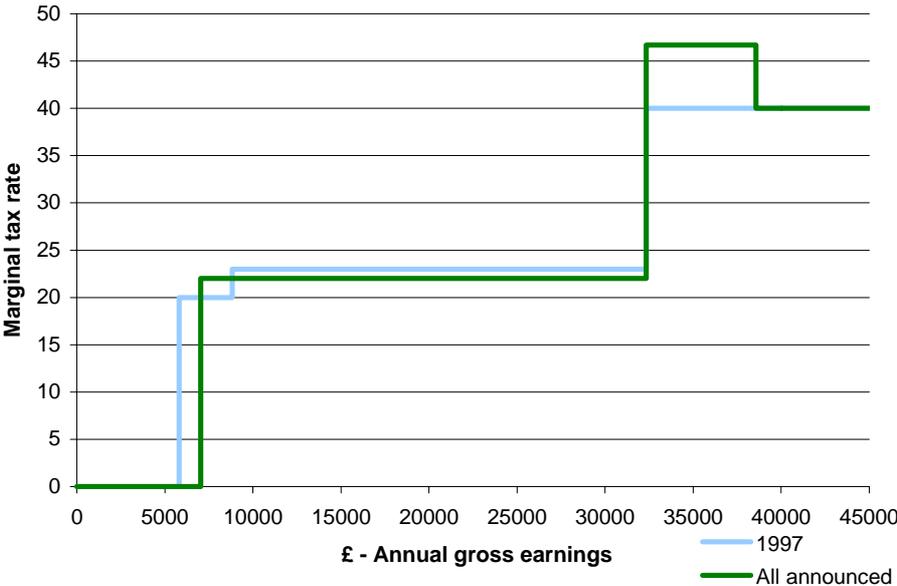
MCA for under-65s. The implication of abolishing the latter is that pensioners' MCA will now be withdrawn completely. Moreover, the MCA has been abolished for all those born after 5 April 1935. This implies that, although the abolition will not affect current pensioners, all those who were born after 5 April 1935 will never receive the allowance even when they become pensioners.

**Children’s tax credit**

The children’s tax credit (CTC) will be available to families with one or more children — it will go to around 5 million families. Its initial value was announced in the 1999 Budget at £416 a year (compared with £197 of MCA). The Chancellor increased it to £442 in the 2000 Budget. In line with the government’s determination to ‘increase substantially support for families with children and to do so in the fairest way’, the credit will contain a redistributive element and will be tapered away for families where there is a higher-rate taxpayer. Once one of the parents reaches the higher tax rate, the CTC will be withdrawn at a 1/15 rate (£1 for every £15 earned above the higher tax band). This implies a marginal tax rate of 46.7% on the first £6,630 earned above the higher tax threshold. The credit will be completely withdrawn once the annual taxable income of either of the parents reaches £35,030 (this corresponds to earning £39,415 if no deductions are made for pension contributions and there is no income from sources other than earnings).

Together with the new 10% and 22% marginal rates, the CTC will give rise to the marginal tax schedule shown in Figure 2.4 (in 1999 prices). The 1997 marginal tax schedule is plotted for comparison (also in 1999 prices) and includes the MCA, 20% lower rate and 23% basic rate.

**Figure 2.4. Marginal income tax rates payable by a married person with dependent children under the 1997 system and under all measures announced in 1997–2000 Budgets (1999 prices)**

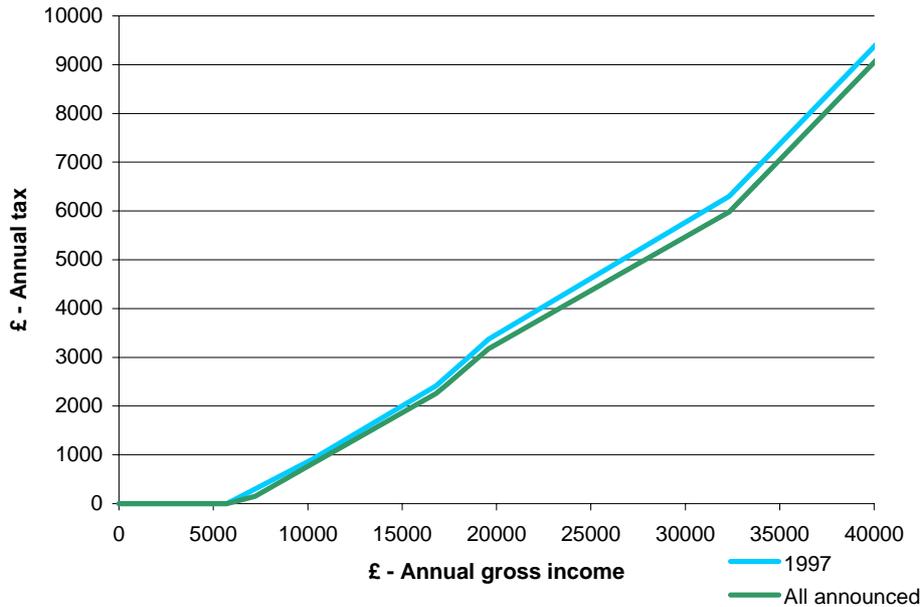


Note: Assuming no deductions for pension contributions and no income other than earnings.

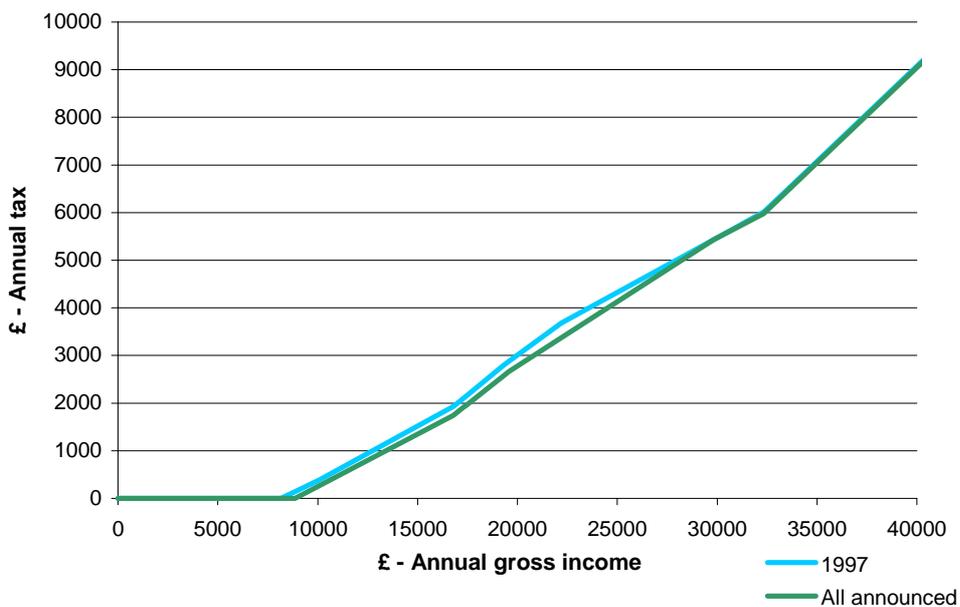
## Age-related personal allowance

The 1999 Budget announced an increase in the age-related personal allowance (coined as 'minimum tax guarantee') by 'up to £200' over inflation. The personal allowance for pensioners aged between 65 and 75 was increased by £130 p.a. and for those aged over 75 by £200 p.a. Age-related personal allowance is withdrawn at half the basic tax rate once gross income reaches

**Figure 2.5. Income tax payable by a single pensioner under the 1997 system and under all measures announced in 1997–2000 Budgets (1999 prices)**



**Figure 2.6. Income tax payable by a married pensioner under the 1997 system and under all measures announced in 1997–2000 Budgets (1999 prices)**



£17,000. For married pensioners, the MCA begins to be withdrawn (at half the restriction rate) once the whole of the age-related personal allowance has been withdrawn.

Figures 2.5 and 2.6 show how the budget constraints of a single pensioner and of a married pensioner with the higher income in the couple have changed, once all announced income tax measures are taken into account (i.e. including the MCA and the new marginal rates). We compare these calculations with constraints facing pensioners in 1997 (all figures in 1999 prices).

### **Working families' tax credit**

The working families' tax credit (WFTC) is a tax credit, which replaced family credit (FC) from October 1999. Its introduction had been recommended in the 1998 Taylor Report<sup>2</sup> and was to 'boost the incomes of low- and middle-income working families with children'.<sup>3</sup>

The credit, announced in the 1998 Budget, is payable to all families with children in which at least one of the partners works at least 16 hours a week. The WFTC is composed of a basic tax credit (£53.15), a tax credit for each child, a credit for those working more than 30 hours a week and a childcare costs tax credit worth 70% of eligible childcare. The childcare costs can be up to a maximum of £100 a week for families with one child and £150 for families with two or more children.

The WFTC is withdrawn at a 55% rate (as compared with a 70% taper for FC) above total net family income of £91.45 a week. From April 2000, it is payable via the wage packet. Relative to FC, the WFTC aims to increase take-up by reducing the stigma associated with claiming in-work support and to reinforce the distinction between the rewards of work and remaining on welfare (Taylor Report, 1998). While the lower 55% taper reduced the number of families facing marginal tax rates above 70%, the number with rates above 60% increased significantly.

**Table 2.2. WFTC under all announced measures**

Credit	Value
Basic credit (for couple/lone parent)	£53.15
Above-30-hours credit	£11.25
Child credit	
under 11	£25.60
11–15	£25.60
16–18	£26.35
Childcare credit	
one child in childcare	70% of childcare costs up to a maximum of £100 ⇒ maximum value of the credit = £70
more than one child in childcare	70% of childcare costs up to a maximum of £150 ⇒ maximum value of the credit = £105

<sup>2</sup> For a copy, see HM Treasury website: <http://www.hm-treasury.gov.uk/budget/1998/taylor.pdf>.

<sup>3</sup> HM Treasury, *Financial Statement and Budget Report*, 1998.

**Table 2.3. WFTC example**

WFTC applicable to a family with two working parents and two children under 11  
(taxes and National Insurance using all announced measures for April 2001)

Gross earnings (father)	£250.00
<i>less</i> National Insurance	-£16.60
<i>less</i> Income tax	-£24.44
Gross earnings (mother)	£100.00
<i>less</i> National Insurance	-£1.60
<i>less</i> Income tax	-£1.57
Total net weekly earnings	£305.79
<i>WFTC</i>	
Basic tax credit	£53.15
Above-30-hours credit	£11.25
Child credit (two children under 11)	£51.20
Childcare credit (for total childcare costs of £150)	£105.00
Total credit	£220.60
<i>less</i> 55% of excess of net earnings over £91.45	-£117.89
Total net weekly income	£408.50

In the 1999 Budget, the government increased the value of the WFTC by raising the basic credit by £2.50 and the under-11 child credit by £4.70 (both increases above inflation). Also in 1999, the government announced that it would increase the under-11 child credit by a further £1.10 above inflation in April 2000 to close the gap in credit between under-11s and 11- to 15-year-olds. The 2000 Budget announced another increase in under-16 child credits, from June 2000, by a further £4.35. Table 2.2 shows the final values of the credits within the WFTC in 2000 prices. Table 2.3 gives an example, which applies the credit to a two-earner couple with two children.

### Company car fuel scales

The 1998 Budget increased the charges on free fuel for private motoring provided by companies to employees with company cars. The in-kind benefit in the form of a company car is subject to income tax payable on 35% of the list value of the manufacturer's retail list price (with reductions for cars older than four years and for cars with high business mileage). The 2000 Budget confirmed a revenue-neutral reform of company car taxation. The new system will be introduced in 2002 and the proportion of the car's list value on which the tax is going to be paid will be related to its exhaust emissions rather than to business mileage.

If companies provide free fuel for private use, it is treated for income tax purposes as a flat amount on which the employee pays the tax. The amount depends on the size of the engine and on the kind of fuel used. The 1998 Budget increased the fuel scale charges by 20%<sup>4</sup> from April 1998 and announced a commitment to increase these charges by a further 20% above increases in pump prices (including fuel duty) in each of the four years 1999–2000 to 2002–03. The changes are summarised in Table 2.4.

**Table 2.4. Company car fuel scales, 1997–2001**

Engine size	Annual scale charges			
	1997–98	1998–99	1999–2000	2000–01
<i>Petrol</i>				
0–1400cc	£800	£1,010	£1,210	£1,700
1401–2000cc	£1,010	£1,280	£1,540	£2,170
2001+cc	£1,490	£1,890	£2,270	£3,200
<i>Diesel*</i>				
0–2000cc	£740	£1,280	£1,540	£2,170
2001+cc	£940	£1,890	£2,270	£3,200
<i>Cars without a cylinder capacity</i>	£1,490	£1,890	£2,270	£3,200

\* Diesel charges were aligned with those for petrol cars of the same engine capacity in the 1998 Budget.

### 3. National Insurance Contributions

Changes made to the structure of National Insurance contributions (NICs) since the 1998 Budget have largely followed the recommendations of the 1998 Taylor Report.<sup>5</sup>

The reforms constitute part of the government's 'making work pay' agenda by decreasing the adverse work incentive effects on low-paid employees and increasing the level of weekly earnings from which NICs begin to be deducted (the lower earnings limit). On the employer's side, the reforms have been aimed at simplification of the NIC system and reduction of administrative burdens by moving it more into line with income tax payments. Recommendations of the Taylor Report were incorporated in the 1998 and 1999 Budgets, with changes to the NIC system planned to take effect in stages until April 2001.

The 1998 Taylor Report put forward the following recommendations:

- increasing the lower earnings limit (LEL) to the level of the income tax personal allowance for employer NICs and (subject to ensuring people do not face unacceptable losses of benefit entitlement) employee NICs;
- abolishing the 'entry fee' and 'steps' for both employee and employer NICs;
- abolishing the Class 2 charge for the self-employed, increasing the Class 4 rate and aligning the lower profits limit (LPL) with the LEL;

<sup>4</sup> See A. Dilnot and C. Giles (eds), *The IFS Green Budget: January 1998*, Commentary 67, Institute for Fiscal Studies, London, 1998.

<sup>5</sup> For a copy, see HM Treasury website: <http://www.hm-treasury.gov.uk/budget/1998/taylor.pdf>.

- progressive alignment of the NIC legislation with income tax, and bringing the operational and policy functions of NICs into the Inland Revenue.

Table 3.1 gives a summary of NIC reforms announced in the 1998 and 1999 Budgets.

**Table 3.1. Summary of NIC reforms**

Reform	Budget 1998 April 1999	Budget 1999 April 2000	April 2001
<b>Employee contributions</b>	'Entry fee' abolished	Zero rate to apply between the LEL and primary earnings threshold (PET) UEL increased from £485 to £535	PET aligned with income tax personal allowance UEL increased to £575
<b>Employer contributions</b>	'Entry fee' and 'steps' abolished Increase in the rate of contributions from 10% to 12.2%; applicable above level of income tax personal allowance	Extended to those in-kind benefits already subject to income tax	
<b>Self-employed contributions</b>		Class 2 flat charge reduced from £6.55 to £2 Class 4 charge increased from 6% to 7% LPL reduced in line with LEL / income tax personal allowance (from £140 to £84) Upper profits limit (UPL) increased from £485 in line with UEL to £535	UPL increased in line with UEL to £575

## Employee contributions

Under the previous NIC system, when gross earnings reached the LEL, which in 1998–99 stood at £64,<sup>6</sup> employee contributions were paid at the rate of 2% on the initial £64 ('entry fee') and at 10% on earnings above the LEL (subject to a cap at the upper earnings limit (UEL)). The 1998 Budget announced abolition of the entry fee with effect from April 1999 at an annual cost of over £1bn. The measure removed distortions in the form of marginal rates of over 100%.

Further changes to employee NICs were announced in the 1999 Budget and included the recommended moves towards aligning the LEL with the income tax personal allowance. As of April 2000, the threshold of earnings above which NICs will be paid (the primary earnings threshold (PET)) increased to £76, with a zero rate applying between the LEL and the new threshold (in order to prevent exclusion of those whose earnings fall between the two levels

<sup>6</sup> All thresholds in this section are expressed in weekly values.

from their entitlement to contributory benefits). The PET will increase further (to £87) in April 2001 when it will be aligned with the personal allowance. From April 2000, the UEL has been increased from £485 to £535, and it will rise further to £575 from April 2001. Figure 3.1 compares employee NICs under the 1997 system and under the system taking all announced measures into account.

**Figure 3.1. Employee National Insurance contributions (1999 prices)**



### **Employer contributions<sup>7</sup>**

The level from which employer contributions begin to be paid has already been increased up to the level of the income tax personal allowance (of £83 per week in 1999–2000), as of April 1999. Employers pay a single rate of 12.2% above this level, which considerably simplifies the system. Before April 1999, employers contributed 3% of all earnings when weekly earnings reached the LEL and did not exceed £113. Thus employers’ payments also included the ‘entry fee’ at the LEL. Employer contributions increased to 5% on earnings up to £160 and to 7% on earnings up to £217. Contributions were charged at 10% on earnings over £217. These percentage charges applied to total earnings, which resulted in payment steps. For example, employer contributions increased by £6.51 when earnings increased from £217 to £217.01 as the applicable rate jumped from 7% to 10%. Thus the 1998 Budget measures removed the ‘entry fee’ and ‘steps’ and simplified the administration of NICs for employers. Table 3.2 outlines employer contributions under the old and the new systems. Figure 3.2 plots the values of the contributions against gross weekly earnings.

Following the Taylor Report recommendation, from April 2000, employer NICs have been extended to those in-kind benefits that are already subject to income tax. Together with increases in the UEL, this has been introduced as a measure to cover the cost of aligning the

<sup>7</sup> As the burden of employer contributions is difficult to allocate to particular households, employer NICs have not been included in our model. The description in this section is given for completeness of the picture of NIC reforms.

earnings level from which employer contributions begin to be paid with the income tax personal allowance. To compensate for the climate change levy, the November 1999 Pre-Budget Report announced a reduction in the employer NIC rate of 0.3 of a percentage point from April 2001, while the 2000 Budget announced a further reduction of 0.1 of a percentage point in 2002.

**Table 3.2. Employer NICs in 1998, 1999 and 2002**

1998 system			1999 system			2002 system		
Earnings range (weekly)	Rate	Applicable on earnings range:	Earnings range (weekly)	Rate	Applicable on earnings range:	Earnings range (weekly)	Rate	Applicable on earnings range:
£0–£66	—	—	£0–£83	—	—	£0–£83	—	—
£66–£113	3%	All earnings	Above £83	12.2%	Above £83	Above £83	11.8%	Above £83
£113–£160	5%	All earnings						
£160–£217	7%	All earnings						
Above £217	10%	All earnings						

Notes: All thresholds are in 1998–99 prices. Reduced rates apply for those contracted out of SERPS.

**Figure 3.2. Employer National Insurance contributions (1998 prices)**



### Self-employed contributions

The government has introduced changes to self-employed NICs based on similar principles to those applied to employee and employer NICs. In the 1999 Budget, the Class 2 flat charge of £6.55 a week on earnings above £69, which was analogous to the 'entry fee', was reduced to £2 to take effect from April 2000. In line with that, the Class 4 charge increased from 6% to 7% in April 2000, applicable on a broader range of profits. The Class 4 charge applies to profits between the lower and upper profits limits (LPL and UPL), which have been aligned with the

income tax personal allowance and the UEL respectively. In 1998, the charge applied to profits between £140 and £485. From April 2000, it applies to profit levels between £84 and £535. The UPL will be increased to £575 in line with the UEL in 2001. As the charge rises and will apply to a broader range of profits, the reforms will bring an increase in government revenue. The Taylor Report pointed out that, under the 1998 system, the self-employed substantially under-contributed to the National Insurance Fund (even allowing for their reduced entitlements). This has been used as a justification for the revenue-raising effect of the self-employed NIC reform package.

Table 3.3 gives a summary of the revenue effects of the NIC reform package.

**Table 3.3. Annual revenue effects of NIC reform**

	Yield (+)/Cost (-) to government	
<b>Employee contributions</b>	Abolition of 'entry fee'	-£1,350m
	Application of zero rate between LEL and new payment threshold	-£1,950m
	Alignment of payment threshold with income tax personal allowance	
	Increase in UEL to £535	+£660m
	Increase in UEL to £575	
<b>Employer contributions</b>	Abolition of 'entry fee' and 'steps'	£0
	Introduction of 12.2% rate applicable above level of income tax personal allowance	
	Extension of NICs to those in-kind benefits already subject to income tax	+£250m
<b>Self-employed contributions</b>	Aggregate impact of reforms	+£250m

Sources: HM Treasury, *Financial Statement and Budget Report*, various years.

## 4. Indirect Taxes

In its first Budget in July 1997, the Labour government delivered its election promise that it would cut VAT on fuel and power from 8% to 5%. This came into effect in September 1997 and has been the most costly VAT reform thus far. The total cost of the tax reduction in 1999–2000 was £510m.

The 1999 Budget increased insurance premium tax by 1 percentage point to 5%, with an estimated revenue gain of £300m p.a.

The government has introduced numerous changes to excise duties. Important reforms have been implemented on tobacco and fuel, with the tax escalator playing an important part in both. The government increased the tobacco escalator in the 1997 Budget from 3% to 5% and the fuel escalator from 5% to 6%. Both tobacco and fuel escalators have been aligned with Budget Day. This gave rise to significant one-off revenue gains for the government as real increases in taxes took place in March (for petrol in 1998, for tobacco in 1999) immediately following increases announced for the previous year which took place in December (respectively 1997 and 1998). Following the Chancellor's Pre-Budget Report in November 1999, the escalators have been

replaced with the policy of 'appropriate level and timing of increases' subject to the Chancellor's 'Budget judgements'.

**Table 4.1. Tobacco, alcohol and petrol duties**

Tax	Tobacco		Beer	Wine	Spirits	Petrol
	<i>Ad valorem</i>	Specific	Specific	Specific	Specific	Specific
1 January 1997	21	131.90	24.00	105.30	532.20	41.68
6 March 2000	22	179.34	26.40	115.81	548.00	54.68
Aggregate % increase	4.76	35.97	10.00	9.98	2.97	31.19
Combined tobacco tax increase	34.36					
Real % change in duties	25.88		1.52	1.50	-5.51	22.71

Note: Inflation index for the period January 1997 to February 2000 is 8.48%.

**Table 4.2. Indirect tax reforms**

	Reform	Announced or confirmed	To take effect from:	Estimated annual budget effect (indexed)
VAT on domestic fuel and power	Rate reduced from 8% to 5%	Budget 1997	Sept. 1997	-£510m
Tobacco duties	Cigarette duty up 5.2% real; tobacco escalator increased from 'at least' 3% to 'at least' 5%	Budget 1997	Dec. 1997	£420m
	5.25% (escalator) real increase in duties	Budget 1998	Dec. 1998	£440m
	Escalator aligned with Budget Day; 5% (escalator) real increase in duties*	Budget 1999	Mar. 1999	£465m
	5% real increase in duties	Budget 2000	Mar. 2000	£415m
Road fuel duties	Road fuels escalator increased from 'at least' 5% to 'at least' 6% real	Budget 1997	Dec. 1997	£1,345m
	Road fuel escalator aligned with Budget Day; differential between diesel and unleaded petrol increased over next three years; differential between diesel and ULSD increased over next two years*	Budget 1998	Mar. 1998	£1,865m
	6% (escalator) real increase in duties	Budget 1999	Mar. 1999	£1,500m
Alcohol duties	Freeze duty on spirits	Budget 1998	Mar. 1998	-£20m
	Freeze duty on spirits	Budget 2000	Mar. 2000	-£20m
Insurance premium tax	Rate increased from 4% to 5%	Budget 1999	Mar 1999	£300m

Sources: HM Treasury, *Financial Statement and Budget Report*, various years.

\* Estimates based on figures from respective *Financial Statement and Budget Report*.

The *ad valorem* tax on tobacco has increased from 21% to 22%.

Taking all these measures together, the real increase in tobacco duties between January 1997 and March 2000 has been almost 26%. At the same time, petrol duties went up by 22.7% in real terms. Table 4.1 gives a summary of the changes in excise duties during this period.

Most important indirect tax reforms and their budgetary effects are outlined in Table 4.2.

## 5. Spending

**Table 5.1. Major reforms to government spending directly affecting household incomes**

Announced	Reform	To take effect from:	Estimated budget effect in a given year
<b>Budget 1997</b>	Restriction of mortgage interest tax relief from 15% to 10%	April 1998	£950m
<b>Budget 1998</b>	Abolition of lone-parent premiums and reduction in income support child premiums for 18-year-olds <sup>a</sup>	April/July 1998	£390m
	Increases in child benefit and means-tested benefits for families with children	April 1999	-£1,220m
<b>Budget 1999</b>	Child benefit: uprating to £15 per week for first child and £10 per week for subsequent children	April 2000	-£255m
	Increases in income support child premiums	Oct. 1999 (£4.70) and April 2000 (£1.05)	-£550m
	Increase in minimum income guarantee for pensioners	April 2000	-£220m
	£100 winter allowance from 1999 for pensioner households	April 1999	-£640m
<b>Budget 2000</b>	Abolition of mortgage interest tax relief	April 2000	£2,200m
	Increase in earnings disregard in income-related benefits from £15 to £20	April 2001	-£20m
	Increase in child allowances in income-related benefits by £4.35 (together with WFTC under-16 child credits)	Oct. 2000	-£1,295m
	Increase in minimum income guarantee capital limits for pensioners	April 2001	-£145m
	£150 winter allowance	Dec. 2000	-£430m
	Uprating of minimum income guarantee for pensioners with earnings in April 2001 <sup>b</sup>	April 2001	-£380m

Sources: HM Treasury, *Financial Statement and Budget Report*, various years.

<sup>a</sup> Effect on the budget estimated using the IFS TAXBEN model; policies announced before May 1997.

<sup>b</sup> Effect on the budget estimated using the IFS TAXBEN model assuming increase in real earnings of 2.5%.

### Measures for families with children

The 1998 *Financial Statement and Budget Report* stated that 'the government is committed to supporting all families with children, in and out of work'. The 1998 Budget announced several

measures aimed at improving the financial position of families with children. Apart from policies introduced as part of the working families' tax credit, the government announced a £2.50 a week real increase in child benefit for the eldest child from April 1999. The family premium in income support was to be increased by the same amount to ensure that the policy also benefited out-of-work families. In addition to this, families on income-related benefits gained £2.50 for each child under 11, a move aimed at narrowing the gap between benefits for younger and older children. At the same time, the government abolished lone-parent premiums in income support and child benefit, a policy announced by the Conservatives in November 1996. The child premiums for 18-year-olds were cut to the level for 16- to 17-year-olds.

Measures to help families with children in the 1999 Budget included the children's tax credit (see Section 2) to be introduced in April 2001. In April 1999, child benefit was increased by £2.95 (announced £2.50 + indexation). Alongside increases in child credits under the WFTC, the government raised under-11 child allowances for families on income-related benefits by £4.70 and announced a further increase of £1.05 from April 2000 to bring the under-11 allowances in line with allowances for 11- to 15-year-olds. The under-16 child allowances were further increased in the 2000 Budget, along with increases in WFTC child credits (see Section 2) of £4.35. Child benefit has been increased by a further 3% in real terms to £15 per week for the first child and £10 per week for subsequent children from April 2000 as a result of announcements made in the 1999 Budget.

**Table 5.2. Benefits to families with children introduced in the 1998 and 1999 Budgets (weekly)**

		1997 (2000 prices)	All announced (2000 prices)*	Reform (increases in real terms)
<b>Child benefit</b>	Only/eldest child lone-parent rate	£18.55	£15.00	July 1998: lone-parent rate abolished
	Only/eldest child couple rate	£12.00	£15.00	April 1999: £2.50 April 2000: 3%
	Other children	£9.75	£10.00	April 2000: 3%
<b>Income support</b>	Family premium (lone-parent rate)	£16.75	£14.25	April 1998: lone-parent rate abolished
	Family premium (ordinary rate)	£11.50	£14.25	April 1999: £2.50
	Child premiums Under 11	£18.00	£30.95	April 1999: £2.50 October 1999: £4.70 April 2000: £1.05 October 2000: £4.35
	11-15	£26.30	£30.95	October 2000: £4.35
	16-18	£31.75	£31.75	

\* All announced figures for child benefit based on specific figures announced in 1999 Budget (rather than on the announced real percentage change).

## Measures for pensioner households

In the 1999 Budget, as part of its programme under the heading 'fairness for pensioners', the government raised the personal income tax allowance<sup>8</sup> and increased the income support premiums (changing their name to minimum income guarantee (MIG)) to £75 (for pensioners aged 65–74). This, together with earnings-linked uprating in April 2000 and announced continuation of uprating with earnings for the remainder of the Parliament, increases income support allowances for single pensioners relative to inflation-indexed allowances by at least £7.35 per week. Pensioner couples gain at least £11.60 per week. The values of allowances following the 1999 and 2000 reforms are presented in Table 5.3 (they include earnings-linked uprating in April 2000 and 2001; the latter assumes a 2.5% increase in real earnings for 2000–01).

**Table 5.3. Changes to pensioner income support allowances resulting from the 1999 and 2000 Budget measures (2000 prices)**

	1997		2001 (including all announced changes)*	
	Single	Couple	Single	Couple
<b>Standard</b>	£73.05	£113.40	£80.40	£125.00
<b>Enhanced pensioner</b>	£75.40	£116.75	£82.90	£128.50
<b>Higher pensioner</b>	£80.40	£122.30	£88.20	£134.35

\* Assumes a 2.5% real increase in earnings for 2000–01.

The 1999 Budget announced a fivefold increase in the winter allowance from £20 to £100 for each pensioner household. The winter allowance will increase further to £150 from December 2000 as a result of an announcement made in the 2000 Budget.

## Mortgage interest tax relief

The policy of the Labour government with respect to tax relief on mortgage interest has been consistent with that followed by Conservative governments, which initially froze the cap of outstanding principal that qualified for the relief at £30,000 and then limited the relief to 15%. The Labour government went further by cutting the relief to 10% in the 1997 Budget and finally announcing its abolition as of April 2000.

Mortgage tax relief has long been criticised as a strongly distortionary measure introducing a bias into the asset-holding decision in favour of owner-occupation. Moreover, existence of the relief was reflected in higher house prices, which prevented new home-buyers from gaining fully from it.<sup>9</sup>

<sup>8</sup> See 'Age-related personal allowance' in Section 2.

<sup>9</sup> See A. Dilnot and C. Giles (eds), *The IFS Green Budget: January 1998*, Commentary 67, Institute for Fiscal Studies, London, 1998.

## **6. Detailed Distributional Effects**

This section shows individually the distributional effects of direct tax, indirect tax and spending changes. It also describes the model on which the results are based. The overall results are summarised in Section 1 above.

### **The model**

The IFS tax and benefit model, TAXBEN, is based on information from the Family Expenditure Survey. This is a representative sample of around 7,000 UK households. From the information on incomes and expenditures, TAXBEN can calculate the effects of tax and benefit reforms on each household in the survey. These can then be aggregated to analyse the effect of reforms on the incomes of particular types of households and to examine aggregate distributional effects. For the results presented here, we compare two fiscal systems. The April 1997 system is used as a benchmark. This is compared with a new system which includes all the budgetary measures that directly affect household income announced since May 1997, whether or not they have already taken effect. The two systems are indexed to 1999 prices.

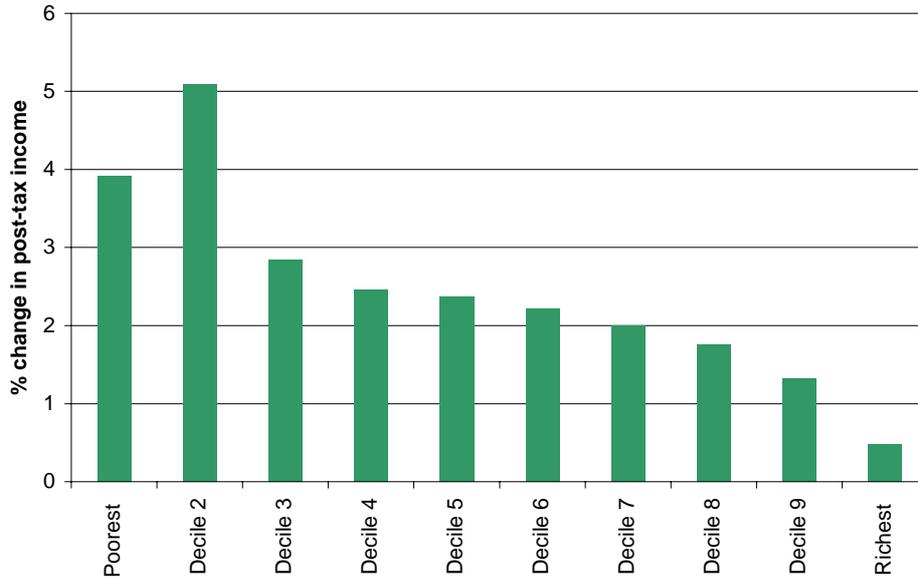
Results show the effect of the modelled fiscal reforms on the post-tax income of households grouped into deciles. Deciles are constructed by dividing UK households into 10 equal-sized groups, ranked by income adjusted for family size. So the first decile contains the poorest 10% of the population, while the tenth decile contains the richest 10%. The decile effects represent the average impact on households in each of these income groups. Results are presented for changes in direct taxes (income tax and National Insurance), indirect taxes and spending. The overall results in Section 1 are broken down by family type as well as by decile.

### **Distributional effects of direct tax changes**

Figure 6.1 shows that the average post-tax income gain as a result of changes to income tax and National Insurance (NI) falls gradually from the fifth to the top decile and is lowest for the richest 10% of households. This can be explained by the fact that as household income increases from a certain level, the income gain due to the new 10% tax rate, the lower basic rate and the higher NI contribution threshold will decline as a proportion of total income. Moreover, for many households in higher deciles, this gain will be offset by increases in the upper earnings limit. It is also likely that many individuals in higher income groups will be subject to company car fuel scale charges and will thus pay higher income tax on free fuel they receive for private use from their employers.

Households in the second decile gain most as a result of the reforms. These are the households most likely to receive the working families' tax credit and to gain from the increased NI contribution threshold and the lower 10% rate. The lowest-decile households on average gain less than households in the second decile as the bottom group contains fewer people eligible for the working families' tax credit paying NI and income tax.

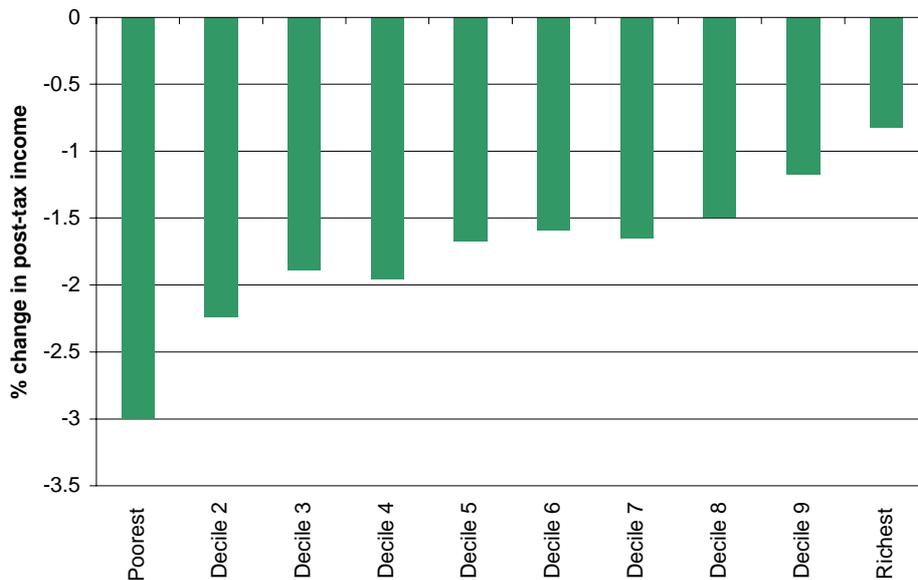
**Figure 6.1. Distributional impact of income tax and National Insurance changes, by decile**



### **Distributional effects of indirect tax changes**

Taken together, changes to indirect taxes since July 1997 have had a negative impact on post-tax incomes across the whole income range, with the most pronounced effects being among the poorest households. Thus on average the effect of reduced VAT on domestic fuel has been outweighed by increases in excise duties on tobacco and road fuel for households in all 10 deciles. Figure 6.2 shows a clear regressive impact of the indirect tax package announced during this Parliament. In proportion to their income, the richest households have been least affected by the reforms.

**Figure 6.2. Distributional impact of indirect tax changes, by decile**



### Distributional effects of spending changes

Reforms to the benefit system since July 1997 have been strongly progressive, as can be seen from Figure 6.3. The proportional post-tax income gain is highest for the bottom-decile households (8.4% on average) and gradually falls for higher deciles, turning negative for all four top deciles. Income gains are highest for poorer households because of increases in means-tested benefits and because increases in the levels of universal benefits (winter allowance for pensioners and child benefit) represent a higher proportion of their income. For the top four deciles, the positive effect of increases in universal benefits is outweighed by the negative impact of the abolition of mortgage interest tax relief.

Figure 6.3. Distributional impact of spending changes, by decile

