

4. Budget options for personal tax and benefits

The government may feel that macroeconomic conditions leave it with some leeway for further fiscal loosening before the general election. If so, it has a number of options in direct tax and benefit policy for how it might implement this. First, it may wish to redirect further resources to one of the groups that it has already prioritised, families with children. Alternatively, it may decide that the time is right for a more general tax give-away, in which case it confronts an additional choice in how it delivers this – a lower basic rate, a wider starting rate and higher allowances, for example, all being possibilities. In this chapter, we review a number of possible alternatives, each of which has roughly equivalent exchequer costs.

4.1 A package for children

This government has increased state support for children dramatically. Although universal child benefit has been increased, most redistribution has been through more targeted measures. The introduction of the working families' tax credit (WFTC) involved substantial new resources, income support for those with children has been increased and, from April, the children's tax credit (which is targeted away from high-income parents) will redistribute further to those with children. Given this track record, it is interesting to ask what further measures the government might introduce to benefit families with children.

A potential part of such a package would be an increase in the generosity of the children's tax credit. Indeed, in the Pre-Budget Report and subsequently, the Chancellor has indicated that he is considering such a move. Under current plans, the children's tax credit will deliver a tax discount of £8.50 per week to families with children where neither parent is a higher-rate taxpayer (which is to say that neither has an income above £33,935 in 2001–02, assuming default indexation). But Gordon Brown has publicly declared that he is 'consulting on a bolder proposal' to increase this value to £10 per week, which would cost £350 million.¹

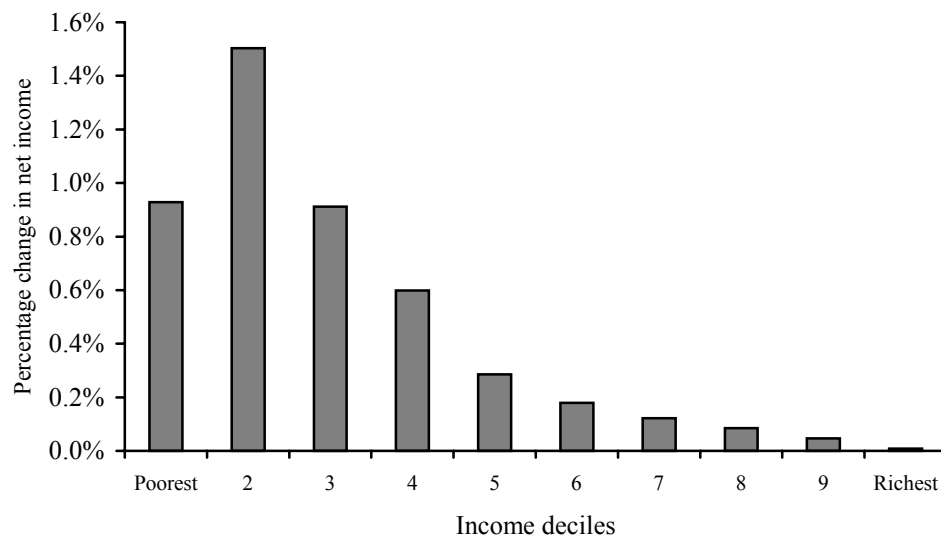
But the children's tax credit alone would deliver no gains to non-taxpaying families. As most of the poorest families pay no tax, the measure would do little to advance the government's strategic aim of eliminating child poverty within twenty years. For this reason, the Chancellor might like to consider undertaking concurrent moves to boost the incomes of poorer families with children.

¹ Speech by the Chancellor of the Exchequer to the National Council for One Parent Families on 5 December 2000.

One possibility would be to increase further the child allowances in income support and WFTC. Any such move might be felt to have a further advantage in smoothing the transition to the proposed integrated child credit discussed in Chapter 7. To date, besides increasing these allowances in general, the government has concentrated considerable resources on increasing those for children under 11 to equate them with those for 11- to 16-year-olds. It could now complete this process by increasing the rates for children under 16 so as to equate them with the support available in respect of 17- and 18-year-old dependants. Under current plans, WFTC credits for children of 16 or under will rise to £26.00, compared with £26.75 for 17- and 18-year-olds. In income support, the respective figures will stand at £31.45 and £32.25, making the requisite increase 80p. These increases remain modest, so the government might like to go further. For example, it could increase the WFTC child credit to £29.00 and the corresponding income support allowance to £34.45. This would mean that allowances for children under 16 had increased by a total of £3 in each of the main means-tested benefits.²

If such a package were combined with the mooted increase in the children's tax credit, the total cost would be around £1.2 billion. Figure 4.1 shows the effect on average incomes across the complete income distribution, which includes both households with and households without children. Overall, the package is strongly progressive, with the biggest effects being at the lower end of the income distribution.

Figure 4.1. Gains across the income distribution from a package of measures to increase support for children



Note: Income deciles are derived by dividing the total population into 10 equally sized groups according to household income adjusted for family size. Decile 1 contains the poorest tenth of the population, decile 2 the second poorest and so on, up to the top decile (decile 10), which contains the richest tenth.

Source: IFS tax and benefit model using Family Resources Survey 1998–99.

² Adjustments to housing benefit and council tax benefit are factored into the reform packages to ensure that gains from this reform are not lost through reductions in these benefits.

But even if the government wanted to redistribute progressively, it remains open to question whether it would want to follow this policy. The extent of the increase in support for families with children so far under Labour has been so substantial that the government might decide that poverty in childless households is now in need of more urgent address. In April 2001, the income support allowance for the youngest children is already scheduled to reach £31.45, a real increase of 72% over the £18.25 that the default inflation indexation of the Spring 1997 allowance would have produced. The corresponding increase in benefit for the lowest-paid families in work has been even greater. Had family credit simply been indexed, each child under 11 would have increased maximum entitlement by £13.00 in April 2001, whereas the corresponding figure for WFTC is actually set to be £26.00, a real increase of 100%. In contrast, since Labour assumed office, income support for childless adults has been frozen in real terms.

In consequence, the extra income support set to be received by a parent in respect of her first child from April 2001 (£45.95) is already considerably higher than the level of income support provided for a young single adult (£42 per week from April 2001).³ Further, the benefit arising for additional children (£31.45 from April 2001) is already higher than that awarded in respect of the second adult in a couple (£30.20 from April 2001). Moves in the direction of the reform package considered here would obviously further extend the relatively favourable position of children in the benefit system.

None the less, the government may wish to push on with its strategic goal of eliminating specifically child poverty, in which case such a package may be seen as an appealing way to complete a term in office that has had this as one of its central aims.

4.2 Personal tax cuts

The Chancellor might prefer that the benefits of any fiscal loosening be felt by all taxpayers, rather than being restricted to those with children. In this section, we consider the distributional effects of some relatively modest income tax cuts, each of which is scaled to cost roughly the same as the package for children considered in the last section. One possibility is a ½p cut in the basic rate of income tax, while alternatives include widening the 10% band (i.e. raising the basic-rate threshold), raising allowances and increasing the higher-rate threshold. Table 4.1 explains the relevant terminology of the income tax system.

Basic-rate tax cut

A ½p cut in the basic rate of income tax, from 22% to 21½%, would cost the exchequer approximately £1.3 billion.⁴ Gains are restricted to those with

³ Income support for the first child is higher than the £31.45 child allowance because it also includes the family premium.

⁴ Unless otherwise stated, figures in this section are calculated using the IFS tax and benefit model run over Family Resources Survey data. Costings differ somewhat from those produced by HM Treasury (reproduced here in the 'ready reckoner' in Appendix E). The latter are

incomes sufficient to pay basic-rate tax: for childless individuals under 65, this means gross income must exceed £6,115. Half a penny is gained for each pound of annual income between this amount and the point where higher-rate tax liability begins. This implies that the maximum possible gain is £139.10 per year (£2.68 per week), which goes to anyone with gross income above £33,935.⁵

Table 4.1. The April 2001 income tax system

Term	Definition	Amount of taxable income	Amount of gross income
Personal allowance	Gross income on which no tax is paid. Income immediately above this is taxed at 10% (the starting rate).	£0	£4,535
Basic-rate threshold	Taxable income at which 22% tax rate (the basic rate) begins.	£1,580	£6,115
Higher-rate threshold	Taxable income at which 40% tax rate (the higher rate) begins.	£29,400	£33,935

Note: The table is for a childless single person under 65 receiving only earned income.

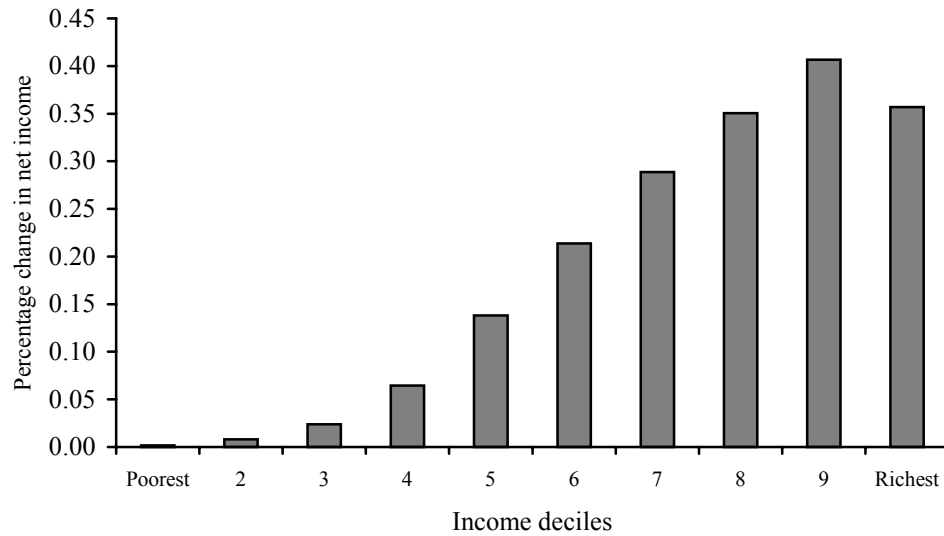
The reform is therefore regressive, as Figure 4.2 shows by plotting percentage gains across the income distribution. This regressivity is even starker when analysed in cash terms. Amongst the bottom 30% of the income distribution, gains are practically zero, which reflects the small numbers of basic-rate taxpayers in these three deciles. In contrast, the largest gains accrue to the top decile, where the average weekly income gain is £2.97 per household compared with an average gain of just 83p across all families.

Being regressive, this tax cut, if undertaken in isolation, would represent a break with the redistributive direction of Budget packages introduced since 1997. The fact that it only affects individuals with income above £6,115 also limits its effectiveness in ‘reducing high marginal [tax] rates at the bottom end of the earning scale’, an aim Labour committed itself to in its 1997 manifesto. For these reasons, the government may seek alternative means to cut tax. We consider these options next.

based, instead, on Family Expenditure Survey data, and they also ignore the exchequer consequences of changes in social security benefit spending produced by tax changes.

⁵ Illustrative figures are for a childless single person under 65 receiving only earned income.

Figure 4.2. Gains across the income distribution from a ½p cut in the basic rate of tax



Note: See note to Figure 4.1.

Source: IFS tax and benefit model using Family Resources Survey 1998–99.

Raising the personal allowance or widening the 10% band

An alternative means of cutting income tax by £1.3 billion would be an increase of £235 per year in the personal allowance over and above the statutory inflation adjustment. This would take its level in 2001–02 to £4,770.⁶ Individuals who would otherwise have a taxable income of less than £235 (i.e. for childless people under 65, those with a gross income of between £4,535 and £4,770) would be floated out of tax entirely.⁷

A second alternative is to widen the 10% tax band by increasing the basic-rate threshold by £470. This would mean that income for a childless adult under 65 would not be taxed at 22% until gross income reached £6,585, as opposed to £6,115 under statutory indexation. This measure would also cost £1.3 billion.

Anyone with gross income above £4,535 would gain from the increase in the personal allowance. The amount of the gain to an individual would depend on the rate at which her last £235 of income is taxed. Somebody whose last £235 is taxed at 10% would gain £23.50 per year (45p per week). If the last £235 is taxed at the basic rate, then the gain is £51.70 per year (99p per week). If the higher rate is paid on the last £235, then the amount is an annual £94.00 (£1.81 per week).

By contrast, in order to gain from the widening of the 10% band, an individual would have to have gross income in excess of £6,115 per year. For childless non-pensioners whose only income is earned, as long as gross income exceeds £6,585, £56.40 per year (£1.08 per week) would be gained.

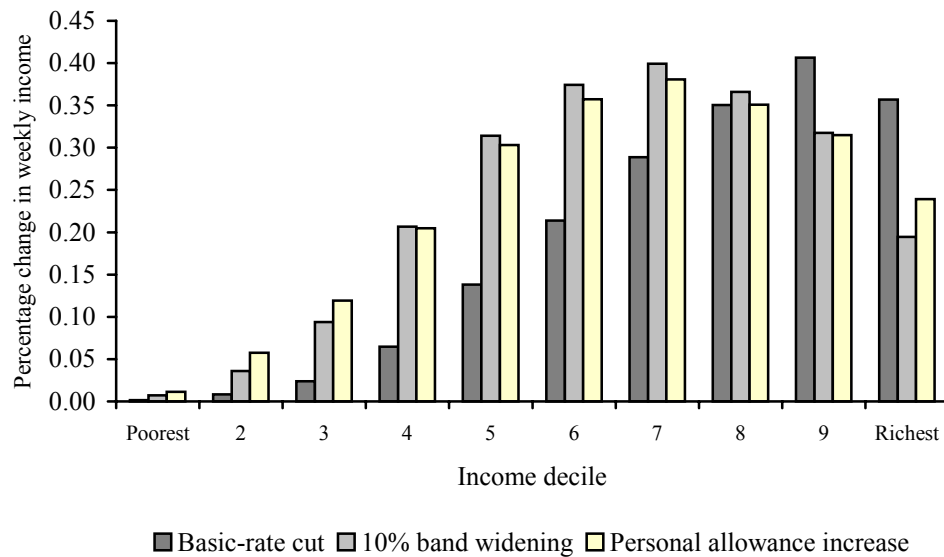
⁶ The larger age-related allowances for pensioners are increased by the same cash amount over and above indexation.

⁷ Illustrative figures assume all income is earned.

From this description of the two reforms, it is clear that the widening of the 10% band is slightly more generous to basic-rate taxpayers, whilst the increase in the personal allowance is the more generous reform for higher-rate taxpayers. Individuals who only pay tax at the 10% starting rate will gain a little from the increase in the personal allowance but not at all from the widening of the 10% band. Compared with the reduction in the basic rate of income tax considered in the previous subsection, both the reforms considered here are more generous to low earners but less generous to high earners. For childless non-pensioners, the basic-rate cut becomes more generous than the widening of the 10% band only once annual gross income exceeds £17,395, and it becomes more generous than the raised personal allowance once income exceeds £16,455.⁸

These distributional points are borne out by Figure 4.3, which compares the percentage gains in income in each decile accruing from each of the three reforms. Whereas the basic-rate cut gives the biggest percentage boost to incomes of households in the second richest decile, the other two reforms are regressive only across the first seven deciles of the population. The graph shows clearly that the overall patterns of gains produced by the latter two reforms are remarkably similar.

Figure 4.3. Gains across the income distribution from alternative direct tax cuts



Note: See note to Figure 4.1.

Source: IFS tax and benefit model using Family Resources Survey 1998–99.

In terms of tackling the poverty trap (the high effective marginal tax rates produced for low-income families by the interaction between taxes and benefits), both a wider 10% band and a more generous personal allowance will bring some benefits. Increased personal allowances remove some individuals from tax altogether and reduce the marginal income tax rate of others, both of

⁸ Illustrative figures assume all income is earned.

which reduce overall effective tax rates.⁹ A wider 10% band would similarly reduce the tax rates faced by individuals whose income was previously just sufficient to leave them facing basic-rate tax. The effectiveness of both measures in tackling the poverty trap is seen in their effect on the marginal tax rates of those currently experiencing rates over 60% because of tax–benefit interaction. The increased allowance reduces effective tax rates for 80,000 such adults, and, amongst these, the average fall in effective marginal tax rate experienced is 16.4 percentage points. Widening the starting-rate band reduces marginal rates for fractionally fewer (75,000) of the target group by a similar average amount, 13.8 percentage points. The Treasury recently estimated that some 950,000 households were exposed to marginal rates in excess of 60% in 1998.¹⁰ Given this, neither tax cut would do more than modestly ameliorate the overall problem of the poverty trap.

Given the similarity of the two reforms, both in terms of distribution and in their effect on work incentives, it may be preferable to opt for wider allowances, as this makes for greater simplicity in two particulars. First, it removes more individuals from the tax net completely, producing commensurate reductions in the number of tax records the Inland Revenue needs to keep.¹¹ Second, widening the 10% band complicates tax administration by increasing the number of individuals who are entitled to a tax rebate on their savings (where default deduction of 20% tax at source means that starting-rate taxpayers are entitled to a rebate worth 10% of their taxable savings income).

Both reforms considered in this subsection are more progressive than the cut in the basic rate considered in the previous subsection, but both remain regressive overall, principally because they do not provide any help to individuals with incomes below the personal allowance. Both reforms would have some – albeit limited – effect in alleviating the poverty trap.

Raising the higher-rate threshold

Over the 1990s, the number of higher-rate taxpayers has increased, principally because the higher-rate threshold has typically been indexed only in line with prices, rather than keeping pace with earnings. The widening earnings distribution has further contributed to the growing numbers with incomes sufficient to pay higher-rate tax. Table 4.2 shows the number of higher-rate taxpayers in alternate financial years since 1990. The total number liable to pay higher-rate tax increased by around 1 million, taking it to 2.7 million by 2000–01. Correspondingly, the level of earnings required before being liable to pay higher-rate tax declined from 76% above the average for a full-time worker in 1990 to just 55% above the average by April 2000. The trends shown by the table actually pre-date the 1990s. In the financial year 1985–86,

⁹ Some individuals facing higher-rate tax will also experience a fall in their effective marginal tax rate, but this group would not normally be thought of as facing a ‘poverty trap’.

¹⁰ HM Treasury, *Budget 2000 – Prudent for a Purpose: Working for a Stronger and Fairer Britain*, HC346, Stationery Office, London.

¹¹ Widening the 10% band (and indeed cutting the basic rate) will still remove a small number of individuals from tax, owing to the workings of various tax credits.

there were just 950,000 higher-rate taxpayers, and in 1980–81, there were only 796,000.

Table 4.2. Changing numbers of higher-rate taxpayers

Financial year	Number of higher-rate taxpayers (thousands)	Higher-rate floor as a % of average earnings ^a
1990–91	1,700	176%
1992–93	1,720	168%
1994–95	2,000	162%
1996–97	2,080	162%
1998–99	2,350	158%
2000–01	2,720	155%

^a Income at which higher-rate tax becomes payable for a single adult (i.e. the higher-rate threshold plus the personal allowance) as a percentage of average earnings amongst full-time employees in April of each tax year.

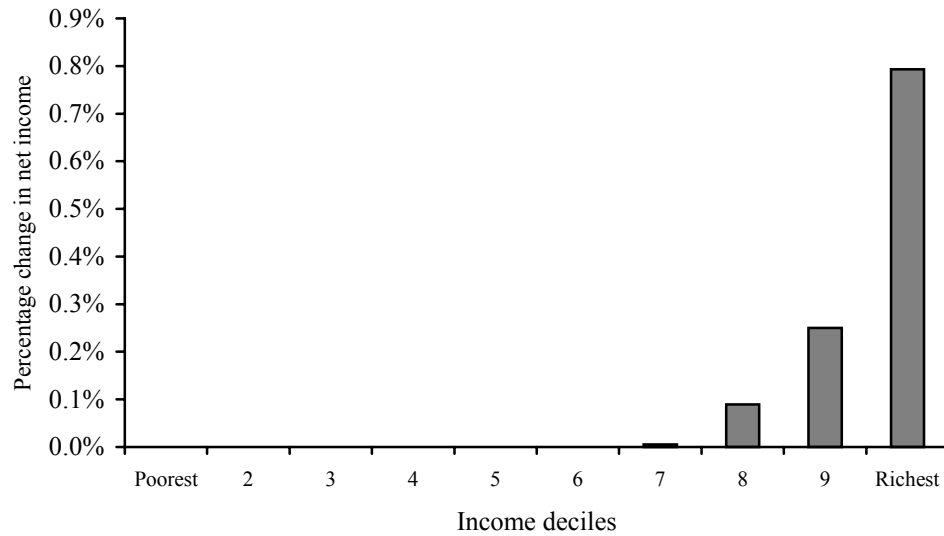
Sources: *Inland Revenue Statistics*, various editions; New Earnings Survey 2000.

As the higher rate now affects people somewhat lower down the earnings distribution than previously, some may feel that an increase in the higher-rate threshold would be timely, with a view to restoring the moderately well-paid to the basic-rate tax bracket. It should be recalled, however, that the average tax rates of those just above the higher-rate threshold remain far closer to the 22% basic rate than to their 40% marginal rate – as most of their income remains in the basic-rate bracket. Further, raising the higher-rate threshold will award tax cuts even to the very wealthiest, as it would reduce the part of their income that is susceptible to higher-rate tax. The only way that gains could be restricted to those on moderately high incomes would be to increase the higher rate simultaneously.

Raising the higher-rate threshold should not, therefore, be seen as a policy targeted at ‘middle England’. This comes through in Figure 4.4, which displays the modelled distributional results for an increase in the higher-rate threshold of £3,400 over and above indexation, taking its value to £32,800. The reform costs around £1.3 billion and would reduce the marginal rate of tax for some 440,000 higher-rate taxpayers to the basic rate. It would be worth £11.77 per week to individuals with incomes above £37,335, and progressively less than that to those with incomes between that level and £33,935.¹² It is worth nothing to individuals with incomes below the latter level. There is virtually no effect on disposable incomes for the bottom 70% of households, and proportional gains in the top three deciles rise sharply with income.

¹² Illustrative figures are for a childless single person under 65 receiving only earned income. Interestingly, the workings of the children’s tax credit mean that, for individuals with children whose income is now just sufficient to deny them any benefit from the credit, an increase in the higher-rate threshold would mean an increase in marginal tax rate, from 40% to 46.7%.

Figure 4.4. Gains across the income distribution from a £3,400 increase in the higher-rate threshold



Note: See note to Figure 4.1.

Source: IFS tax and benefit model using Family Resources Survey 1998–99.

4.3 Conclusion

This Budget might well involve some fiscal loosening, and if it does, it is highly likely that a substantial proportion of this will be brought about by either lower direct taxes or more generous transfer payments. If the government's main concern is securing redistribution, either towards low-income families or towards other target groups, then more generous social security benefits will be most effective. Income tax cuts represent an alternative less in keeping with the distributional principles underlying economic policy since 1997, although important distinctions remain between how the gains from different types of income tax cut are distributed. For example, widening allowances offers a less regressive outcome than a basic-rate cut.

Tom Clark and Matthew Wakefield