

18 million families set to lose if ‘one-off’ giveaways not extended

Eighteen million families will be worse off¹ by an average of more than £150 a year from tax and benefit changes over the next two years, unless the Government finds the money to extend last week’s ‘one-off’ income tax cut and to continue topping up the winter fuel allowance, according to analysis by IFS researchers.²

The increase in the personal income tax allowance announced on May 13 means that (using Treasury costings) the Government is now giving away £5.5 billion this year through the various income tax, National Insurance, tax credit and benefit changes announced in Budget 2007 and subsequently – the largest such package since the general election year of 2001–02. Of this, around £2.6 billion is being financed through increases in other taxes (including green taxes, capital gains tax, business rates on empty properties and anti-avoidance measures) and around £2.9 billion by increased borrowing. The May 13 “mini-Budget” was a bigger giveaway – if maintained – than in any Budget or Pre-Budget Report since 2001, when the outlook for the public finances appeared much stronger.

Some 21.3 million families will be better off this year than they would have been without the personal tax and benefit changes announced in Budget 2007 and subsequently. But 0.9 million families will still be worse off than they would have been in the absence of these changes.

In fact, 6 million individuals will still pay more income tax this year as a result of the abolition of the 10% tax band, despite the increase in the personal allowance: these are people under 65 on incomes between £6,635 and £13,355, with the biggest loss of £112 a year at £7,755. But most of these 6 million individuals either live with a spouse or partner who gains more than they lose, or are fully compensated by increased benefits and tax credits.

The 0.9 million families who are still worse off overall this year as a result of the reforms in Budget 2007 and subsequently include:

- 500,000 childless single adults under 25 (almost all living in a household with other adults);
- 140,000 childless couples where at least one is aged 25 to 55, and;
- 115,000 childless single adults aged 25 to 55.

The losing families have an average income after taxes and benefits of £11,800. More than two-thirds are in the poorest third of the population. These families lose around £83 a year on average, with the poorer among them losing a larger proportion of their income than the richer ones.

In the absence of further policy changes, the next two years would see many families made worse off as the ‘one-off’ income tax cut and this year’s higher winter fuel payments disappear, and as the upper earnings limit for National Insurance contributions rises (partially offset by the rise in the higher rate threshold for income tax). But low-income families with children will gain from planned tax credit and benefit increases to help reduce child poverty.

Some 18 million families would be worse off in 2010–11 than they are in 2008–09 as a result of these changes, with 3.6 million families gaining and 10 million broadly unaffected. Reversing the increase in the personal allowance would mean that 5.4 million families would not have been compensated in a lasting way for the abolition of the 10% band. Chancellor Alistair Darling said in the House of Commons on 13 May that “our aim is to continue the same

level of support for those on lower incomes”, which suggests that he will try to ensure that at least as many of this group are compensated in future as are being compensated this year by the increase in the personal allowance.

Given the Government’s new-found reluctance to increase families’ tax bills, it also seems unlikely that it will wish to inflict more losses than it has to on the 13 million mostly middle-income families who did not lose from the Budget 2007 reforms, but who have nevertheless gained from the increase in the personal allowance. But retaining the higher personal allowance would require the Government to find around an extra £2.7 billion a year, while keeping the winter fuel payment at its winter 2008 level would require another £575 million a year.

So what are the Government’s options in the Pre-Budget Report?

- **Reaching the low income families that have not been compensated for the loss of the 10% band by the higher personal allowance:** Increasing the personal allowance even further would compensate some of the remaining 0.9m losers, but with most of the gains going to other families that are much better off. As most of the remaining losers are young and on low earnings, another option would be to maintain the higher personal allowance and to extend eligibility for Working Tax Credit. Extending it to those aged 21 or over and working at least 16 hours a week would reduce the number of losers by a further 300,000 and cost another £1 billion if it were fully taken up. But, given how few families without children currently take up the WTC to which they are entitled, the cost and the number of losers compensated would probably be much smaller.
- **Reducing the cost of the higher personal allowance, while maintaining current support for low income families:** If the Government is willing to inflict losses on the middle-income families that have gained both from Budget 2007 and from the increase in the personal allowance, then the cheapest way to maintain the current level of support for those on low incomes would be to withdraw (‘taper away’) the personal allowance (or a re-introduced 10p band) from those with higher incomes. Under the most obvious variant, this is equivalent to increasing the basic rate of income tax back from 20% to 22% on incomes between £7,755 and £19,355. This would cut the cost of maintaining the higher personal allowance by about a third (£860m) to £1.9 billion, but would leave almost 12 million families worse off than they are this year. Tapering would also make the income tax system much more complicated and costly to administer and comply with. Having set out in Budget 2007 to reduce the number of income tax bands from three to two, the Government would have ended up increasing it from three to four with no economic rationale.
- **Reducing the cost of the higher personal allowance, while accepting some rise in the number of losers:** Freezing the personal allowance at its 2008–09 level would be equivalent to a real cut of around £200 and would thus take back about a third of the £120 gain received by each basic rate taxpayer this year. Like tapering, this would cut the ongoing cost of the higher personal allowance by about a third. But it would create fewer losers, leaving 8.3 million families worse off than they are this year. Alternatively, the Government could increase employee National Insurance contributions by 0.3 percentage points. Again this would recoup about a third of the cost of maintaining the higher personal allowance. It would leave 9.6 million families worse off than this year. These policies would both add to the 0.9m families that have not so far been compensated in a lasting way for the abolition of the 10% band – by 1.3m and 0.6m respectively.
- **Realigning income tax allowances and National Insurance thresholds:** One aim of Budget 2007 and earlier reforms was to align income tax allowances and thresholds with those for National Insurance contributions. This would be undone if the higher income tax allowance for 2008–09 were maintained. Lifting the National Insurance earnings threshold to match the higher personal allowance would cut

employees' National Insurance contributions by £1.5bn, compensating two-thirds of the remaining losers from the abolition of the 10% band. It would also cost £1.8bn in employers' National Insurance contributions. (The economic impact of cutting employees' and employers' NICs is in fact the same.) Freezing the personal allowance and raising the National Insurance earnings threshold to match it would leave low earners' combined income tax and employee National Insurance contributions broadly unchanged from this year, but would reduce Government revenues from employer contributions by £1.3 billion.

This analysis suggests that the Government will find it hard to reduce significantly the number of residual losers from the abolition of the 10p rate at a cost that it would find acceptable. It will also be difficult to recoup much of the £2.7 billion cost of the higher personal allowance for 2008–09 in future years without leaving many middle-income families (and perhaps some low-income ones) worse off over the next two years than they are this year. Given the political pressures it faces, this suggests that the Government may well decide to borrow more to maintain the higher level of the personal allowance in coming years, just as it has chosen to do this year. This would leave taxpayers to pick up the bill in future years.

A separate study by IFS researchers assesses how affordable this would be.⁴ It finds that, other things being equal, a one-off £2.7 billion tax cut would take the Treasury's forecast for public sector debt to within a whisker of its self-imposed ceiling of 40% of national income under the sustainable investment rule. An ongoing tax cut of this size would see debt expected to breach the ceiling by about £5 billion in today's terms in 2010–11. The expected breach would be larger if the Treasury had to downgrade its forecasts for economic growth in line with those of bodies like the International Monetary Fund, as this would weaken tax revenues and push up borrowing.

However, the Treasury hopes that it can avoid having to predict a breach thanks to upward revisions to the official estimate of national income planned for this year's National Accounts 'Blue Book'. Experimental estimates from the Office for National Statistics suggest that a change to the treatment of financial services may increase the measured level of national income by around 2%. This would raise the debt ceiling by around £12 billion. Given the impact of this and other possible revisions, we cannot yet predict whether the Treasury will have to forecast a breach.

Insofar as the Government feels it has any leeway to increase spending within its fiscal rules, any money spent retaining the higher personal tax allowance reduces the amount available to spend on meeting other objectives. To name but one, the cost of retaining the higher personal tax allowance is roughly the same as the amount that we estimated after Budget 2008 would need to be spent increasing the Child Tax Credit and Working Tax Credit to reduce child poverty by a further 450,000, thereby giving the Government a roughly 50/50 chance of meeting its target for 2010–11. Increasing the personal allowance is in itself of little benefit to most families in poverty and by increasing median income would also raise the level of income families require to be above the poverty line.

Robert Chote, Director of the IFS, added:

“By announcing a big ‘one-off’ increase in the personal income tax allowance, Alistair Darling has not only created millions of winners this year; he has created millions of potential losers next year. On the evidence of its recent decisions, the Government may well be afraid to take their gains away from them. If public sector borrowing ends up permanently higher as a result, it will further undermine the credibility of the Government's management of the public finances and increase the probability of future tax increases or spending cuts – perhaps soon after the next general election.”

ENDS

Notes to editors:

1. We define a family (or 'benefit unit') as a single adult or couple living together, plus any dependent children. We describe a family as losing if it loses more than £1 a week and gaining if it gains more than £1 a week; otherwise we describe them as broadly unaffected.
2. "The 10p tax rate: where next?", by Stuart Adam, Mike Brewer and Robert Chote, IFS Briefing Note 77, <http://www.ifs.org.uk/bns/bn77.pdf>
3. The analysis looks only at the impact of changes in income tax, National Insurance, tax credits and social security benefits. It ignores other changes in indirect taxes, capital taxes and corporate taxes, all of which are ultimately borne by individuals and families.
4. "Alistair Darling's mini-Budget: can he afford it?", by Robert Chote and Carl Emmerson, IFS Briefing Note 78, <http://www.ifs.org.uk/bns/bn78.pdf>