The 10% tax rate: where next?

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Summary

Changes to income tax, National Insurance, tax credits and state benefits announced in Budget 2007, PBR 2007 and Budget 2008, and the higher personal allowance announced on 13 May, together represent a net tax cut of £5.5bn in 2008–09 (or £6.3bn when the full effect of measures taking effect this year is factored in). Around £2.6bn of this giveaway is financed from other tax and spending measures, with £2.9bn financed from borrowing.

As a result, 21.3m families are better off in 2008–09 than they would have been without any of these announcements, but there remain 0.9m families for whom the tax cuts and increased spending on tax credits and benefits do not compensate for the losses from the abolition of the 10% tax band. Around half of this group are single people under 25, but almost all of those live in households with others who may be net beneficiaries from the reforms.

If the higher personal allowance in 2008–09 is assumed to disappear in future years, then there is much less long-term compensation for the abolition of the 10% tax band. By 2010–11, 5.4m families will be worse off as a result of the announcements in Budget 2007, PBR 2007 and Budget 2008. Most of these will be working-age families without children who are not receiving tax credits, because they are either too young, not working full-time, too rich, or not claiming their entitlements.

The substantial extra spending on families with children announced in Budget 2007, PBR 2007 and Budget 2008 to take effect by 2010–11 is set to increase average incomes amongst low-income families with children, as part of the Government's drive to reduce child poverty. But not repeating the 'one-off' increases for 2008–09 in the personal allowance and in winter fuel payments will result in all family types except those with children losing on average from personal tax and benefit changes between 2008–09 and 2010–11 – around 18m families in total. It thus seems highly implausible that the Treasury can begin planning the tax system for 2009–10 with a blank sheet of paper; the increased personal allowance for 2008–09 is likely to be the baseline from which planning will start.

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If the Government is willing to inflict losses next year on the middle-income families that are benefiting from the increase in the personal allowance this year, the cheapest way for the Chancellor to achieve his goal of maintaining the current level of support for the low-income beneficiaries would be to taper the personal allowance (or taper a re-introduced 10% band) – equivalent to increasing the basic rate of income tax from 20% to 22% on incomes between £7,755 and £19,355 in the current tax system. This would cut the cost of the increase in the allowance by about a third, from around £2.7bn this year to £1.8bn next year. Complicating the income tax system in this way would also make it more costly to administer and comply with, and considerably harder for individual taxpayers to understand. It would be ironic if a set of tax reforms originally designed to reduce the number of income tax bands from three to two ended up increasing it to four with no underlying economic rationale.

Freezing the personal allowance at its 2008–09 level of £6,035 or modestly increasing employees' National Insurance contributions would save similar amounts of money, but mean that up to 1m more families would no longer be fully compensated for the abolition of the 10% band.

Extending eligibility to the WTC to younger and part-time workers without children could compensate some of those who are still losing from the abolition of the 10p rate, but such measures are not comprehensive enough to be a viable alternative to the higher personal allowance. Furthermore, with take-up of WTC so low amongst those without children, it cannot be wise to rely on tax credits as a way to compensate reliably for losses in income tax.

Increasing the personal allowance in isolation undoes Gordon Brown's efforts to align income tax and NICs. Should he continue the higher personal allowance, then bringing the NI earnings thresholds up to match it would cost another £3.3bn a year (although this would be extremely effective in compensating almost all the remaining losers from the abolition of the 10% tax band). Freezing the personal allowance and raising the NI threshold to match would leave low earners' combined income tax and employee NICs bills broadly unchanged, but would reduce revenues from employer NICs.

1. Introduction and methods

In Budget 2007, the Government announced the abolition of the 10% starting rate of income tax alongside a wider set of reforms to personal taxes and tax credits to take effect during the period April 2008 to April 2010. Further changes to tax credits and state benefits were announced in PBR 2007 and Budget 2008, some to take effect in 2008–09, some in 2009–10 and others in 2010–11.

During April 2008, the Government said that it was looking at ways of compensating the net losers from these changes (in practice, those for whom the losses from the abolition of the 10% band exceeded the gains from the other measures). On 13 May it announced a £600 rise in the income tax personal allowance for 2008–09, with a corresponding cut in the higher-rate threshold.

In the light of these changes, this note looks at:

- To what extent the rise in the personal allowance, and other measures in Budget 2007, PBR 2007 and Budget 2008, compensate those who lost out from the abolition of the 10% rate of income tax;

- To what extent the Government's pre-announced changes to personal taxes, tax credits and benefits for 2010–11 provide compensation for these losers over the medium term;

- What options the Government has for 2009–10 and beyond.

As well as the changes already referred to, there will also be a number of "default" changes to the tax and benefit system over the period to 2010–11 (e.g. the uprating of income tax allowances and thresholds in line with inflation) that do not appear as costed policy changes in the Budget and PBR documents, but which nonetheless affect the public finances and what people pay in tax and receive in benefits and tax credits. Who wins and loses, and by how much, depends on which measures you are looking at and when.

Even before the announcement of the £600 rise in the income tax personal allowance, the Treasury argued that some losers from the abolition of the 10p tax band had already been compensated by measures announced in PBR 2007 and Budget 2008 (although this was not cited as an objective at the time). Reflecting the measures that have been announced in and since Budget 2007 – and the fact that various parameters of the system have been uprated automatically with the transition to a new tax year – in section 2 we analyse the winners and losers by comparing three alternative tax and benefit systems:

- "**2008–09 actual":** The actual tax and benefit system in 2008–09, including the backdated £600 rise in the personal allowance

- **"2008–09 no reforms":** The tax and benefit system as it would have looked in 2008–09 had there been no policy announcements in Budget 2007, PBR 2007 or Budget 2008, but if instead the usual default uprating had taken place between 2007–08 and 2008–09. [1]

- **"2008–09 all reforms":** The tax and benefit system as it would have looked in 2008–09 had all the reforms announced in Budget 2007, PBR 2007 and Budget 2008 due to be in place in 2010–11 been implemented in 2008–09. Note that the Government has only promised the £600 rise in the personal allowance for 2008–09, and it has not promised to continue the higher winter fuel payments promised for winter 2008 in future years, so neither is included in this scenario.

The Chancellor has said that he will set out plans for 2009–10 in PBR 2008, and we examine some of his options in section 3.

Box 1 gives more detail on the calculations referred to throughout this note.

Box 1. Modelling winners and losers from tax changes

The modelling analysed in this note is based on the 2005–06 Family Resources Survey, a detailed government-funded survey of over 40,000 adults, together with the IFS' tax and benefit microsimulation model, TAXBEN.

Family or household level?

All analysis of winners and losers in this note is at the 'family' level. This means that the income of all individuals in a family is added together before considering whether a tax change has made a family better or worse off, so that a fall in income experienced by one adult might be offset by a gain experienced by their partner. This method is consistent with that originally used after Budget 2007 to identify that 5.3 million families would lose. Our definition of the family (or 'benefit unit') means a single adult or co-resident couple plus any dependent children: thus elderly relatives or grown up children living in the home would count as separate families, as would siblings or young professionals sharing a flat.

The distributional analysis done by the Treasury is usually performed at the `household' level (in other words, income of all individuals in a household is added together, so that a fall in income experienced by one adult might be offset by a gain experienced by someone else in the household). As we show

[1] This means that, as well as ignoring inflation uprating of tax and benefit rates and thresholds, we do not consider the impact of the following real changes to personal taxes and benefits: the increase in the pension credit guarantee and the child element of the child tax credit in line with earnings, the freezing of the WTC threshold and family element of the child tax credit. We also ignore any real changes in council tax.

later, fewer (in absolute and proportionate terms) households lose than families, often reflecting the fact that parents who gain could compensate offspring living at home who lose, although they may choose not to do so.

If separate families in the same households do share their resources, so that a family who gains from a set of tax changes compensates a family in the same household who loses, then it would be more sensible to do all analysis at the household level. But while this assumption might be true in some cases where all members of a household are related to each other, it is less plausible in cases where a household consists of several unrelated single adults sharing a house.

The IFS Green Budget 2008 (chapter 14) contained an analysis of the changes to the tax system that were due to take effect in April 2008. That included indirect tax changes and, because data on expenditure is collected only at the household level, also contained a distributional analysis at the household level, and this is why it identified 3.6m households losing (by more than £1 a week) in April 2008, rather than 5.3m families.

What counts as a "loser"?

In deciding whether a set of changes to taxes and benefits leaves families better of worse off, we treat those experiencing changes of £1 a week or less as being "broadly unaffected". We understand that the Treasury treats changes of 5p or less as "no change", and this difference means that the Treasury should estimate there to be more losers (and winners) than we do.

In practice, the number of households who lose by more than 5p a week (as reported by HM Treasury) is often very similar to the number of families losing by more than £1 a week (as reported by IFS).

Full take-up

Unless stated otherwise, all calculations are of tax liabilities and benefit entitlements rather than actual payments made. In other words, we assume full take-up of means-tested benefits and tax credits (and no evasion or fraud). We would argue that this is a reasonable approximation for all except the working tax credit for those without children, where take-up in expenditure terms is just 25%.

Employer National Insurance contributions

Because the UEL is due to change (slightly) in real terms over the next few years, the revenue raised from employer NI will also change very slightly, because the contracted-out rebate for employers' national insurance is only available on earnings below the UEL. However, this is ignored in all of the estimated costs, and the analysis of winners and losers, except the estimates of the cost of changing the NI earnings threshold in section 3.3.

2. Analysis of winners and losers from reforms announced to date

This section examines the extent to which the backdated £600 rise in the personal allowance, and other measures in Budget 2007, PBR 2007 and Budget 2008, compensate those who lose out from the abolition of the 10% rate of income tax in 2008–09. It also examines how the extent of this compensation changes if we look ahead to measures announced in Budget 2007, PBR 2007 and Budget 2008 that will be in place in 2010–11.

To do that, we therefore compare:

i. **the '2008–09 no reforms' and '2008–09 actual' tax and benefit systems.** This comparison shows the net effect of all reforms affecting families this year (regardless of when they were announced); it thereby assesses the extent to which the Government has successfully compensated the losers from the abolition of the 10% band in this tax year.

ii. **the '2008–09 no reforms' and '2008–09 all reforms' tax and benefit systems.** This comparison shows the net effect of all reforms due to affect families in 2010–11; it thereby assesses the extent to which reforms announced in Budget 2007, PBR 2007 and Budget 2008 compensate the losers from the abolition of the 10% band in a lasting way.[2]

iii. **the '2008–09 actual' and '2008–09 all reforms' tax and benefit systems.** This shows the net impact of the additional reforms announced in Budget 2007, PBR 2007 and Budget 2008 for implementation by 2010–11 that are not in place in 2008–09. Note that this includes the removal of two one-off measures announced for 2008–09: the change in the personal allowance and the higher winter fuel payment.

Table A1 lists the changes to income tax, National Insurance contributions, tax credits and state benefits announced in Budget 2007, PBR 2007, Budget 2008 and on 13 May considered in this note, noting when they take effect and for how long they are costed to last. Table 1 gives our estimate of their costs alongside the information given about their costs in Budgets and PBRs: we estimate the changes taking affect in 2008–09 are costing the Government £6.3bn a year.[3]

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[2] For simplicity, and to allow us to abstract from inflationary adjustments, the analysis assumes all measures announced for 2010–11 were implemented in 2008–09.

[3] The Treasury's estimate is considerably below ours, but our estimate is on an accruals basis, whereas the Budget tables give the impact on a National Accounts basis, which in some cases (such as self-assessment income tax) estimates the cash flow rather than the liability accrued; some of the reduction in tax liabilities in 2008–09 does not show up in reduced revenues until subsequent years.

The changes for April 2008 relative to April 2007 represent one of the biggest year-on-year personal tax and benefit give-aways in recent years. However, Budget 2007, PBR 2007 and Budget 2008 announced a number of other measures that gave away money (e.g. cuts in inheritance tax) or raised money (e.g. increases in capital gains tax, fuel duty and anti-tax avoidance measures in 2008–09). In the end, all taxes – personal or corporate – are effectively paid by individuals and families.

Table 1. Estimate of the total cost of reforms under consideration in this note

	HM Treasury	*IFS*
April 2008	£5,545m	£6,340m
of which		
Budget 2007	*£2,060m*	
PBR 2007	*£210m*	
Budget 2008	*£575m*	
Finance Bill 2008	*£2,700m*	
April 2010	£3,780m	£4,450m
Memo: cost of one-off higher WFP in winter 2008	£575m	£560m
Memo: cost of £600 rise in personal allowance	£2,700m	£2,750m

Note: HMT estimates taken from various Tables in Budgets and PBRs and the Chancellor's statement to the House of Commons, 13 May 2008; IFS estimates calculated using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2005–06 Family Resources Survey.

Section 2.1 examines the net effect of all reforms affecting families this year, and section 2.2 examines the net effect of all reforms due to affect families in 2010–11. Section 2.3 concludes.

2.1 The effect of changes in 2008–09

The position after Budget 2007, and the impact of abolishing the 10% band without the £600 increase in the personal allowance

After Budget 2007, we estimated that 5.3m families would be made worse off by measures announced in that Budget.[4]

[4] We felt that the best way to capture the impact of Budget 2007 was to ask how much better or worse off people would be in 2007–08 if all the measures announced in the Budget were brought in immediately (including those postponed until later years) compared to what the 2007–08 tax and benefit system would have looked like had Budget 2007 simply not happened. This was the comparison which generated the often-repeated statistic that 5.3 million families would lose, a figure that we gave in evidence to the Treasury Select Committee enquiry in April 2007 (HC-389 II 2006-7, *The 2007 Budget*, Ev 12, Q61), with additional information available from the IFS' post-Budget 2007 conference (http://www.ifs.org.uk/budgets/budget2007/distribution.ppt) and which was broadly endorsed by the Treasury in their evidence (HC-389 II 2006-7, *The 2007 Budget*, Ev 29, Q189 &

To understand how this comes about, it is worth first considering the impact in isolation of the original income tax changes announced in Budget 2007 on an individual taxpayer. (Should the £600 rise in the personal allowance in 2008–09 prove to be a one-off, then this is also a good guide to the income tax systems of 2009–10 and 2010–11, except that it does not allow for the usual indexation of allowances in line with inflation).

If the 2007–08 income tax schedule had simply been uprated in line with inflation, in 2008–09 people under 65 would have paid no income tax on the first £5,435 they earned, 10% on the next £2,320, and 22% on the next £33,680. Instead, the Budget 2007 reforms meant that (before the backdated £600 rise in the personal allowance) they would have paid nothing on the first £5,435 and 20% on the next £36,000.[5] Budget 2007 also announced increases in the UEL for 2008–09 and 2009–10, and an increase in the higher-rate threshold for 2009–10. These changes would have meant that:

- People aged under 65 with non-savings income between £5,435 and £19,355 would have paid more income tax as a result of the Budget 2007 changes, because they lost more from the abolition of the 10% rate than they gained from the cut in the basic rate. This loss is greatest, at £232 a year, for someone earning £7,755, the top of where the 10% band would have been.

- Most people aged under 65 with non-savings income between £19,355 and around £40,000 gained noticeably from the Budget 2007 income tax changes, with the biggest gain, of £336 a year, at an income of £36,140. These people gain more from the cut in the basic rate than they lose from the abolition of the 10% band and the rise in the upper earnings limit for National Insurance contributions.

- Budget 2007 changes to the levels of income at which people stop paying the full rate of National Insurance contributions and start paying the higher (40%) rate of income tax mean that most people with incomes above £40,000 will gain only marginally once all the Budget 2007 measures have taken effect by April 2009.

Figure 1 shows the changes announced in Budget 2007 to take effect in April 2008.

These tax changes in isolation would have tended to benefit the rich more than the poor (although they leave the richest – those paying higher-rate income tax

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Q190), although the then Chancellor was less keen to endorse it (HC-389 II 2006-7, *The 2007 Budget*, Ev 46, Q308). Box 1 gives more detail of the methodology we use.

[5] For simplicity, we describe the tax schedule that applies to individuals with no taxable savings income.

– and the poorest – those with incomes too low to be liable for income tax – largely unaffected). But Budget 2007 also announced extra spending of £1 billion raising tax allowances for those aged 65 and over, and £1.7 billion raising the child and working tax credits; PBR 2007 and Budget 2008 added another £785m in higher child tax credit and a one-off £575m rise in winter fuel payments next winter.

The Budget 2007 changes in particular were carefully calibrated to ensure that various groups were protected from the abolition of the 10% band, and so the combined effect of all Budget 2007 changes was that:

- no individual aged 65 or more was paying more income tax as a result of the reforms,[6] and many were paying less because of the rise in the extra tax allowances for those aged 65 or more.

- single-earner families receiving tax credits were no worse off as a result of the reforms (because of the increased generosity of the child and working tax credits). Those with children were mostly better off.

This meant that, before the £600 backdated rise in the personal allowance in 2008–09, the expected losers fell into two groups:

- Families without children not receiving tax credits in which at least one adult earned between £5,435 and £19,355. These fell into four distinct groups:
    - families in which all adults were aged under 25;
    - families in which no adult worked 30 hours a week or more (including retirees under state pension age);
    - families whose income was too high to be entitled to tax credits (around £12,900 for single adults without children, and £17,400 for couples without children); and
    - families not claiming the tax credits to which they were entitled.[7]

- Couple families receiving tax credits but with two earners, each paying more income tax as a result of the reforms, where the increased

[6] In certain unusual circumstances it was possible for someone aged 65 or over to lose, notably if they had non-savings income (including pension income) below £19,355 but sufficient savings income to take their total income above £28,990.

[7] In expenditure terms, the take-up rate of WTC of those without children is just 25%.

entitlement to tax credits may not have been enough to compensate for two adults paying more income tax.

Recalculating the number of losers taking account of all measures in Budget 2007, PBR 2007 and Budget 2008, we now estimate that 5.2m families would have fallen into these categories and been worse off in 2008–09, if all those entitled to tax credits took them up. If no-one without children took up the working tax credit to which they were entitled, the number of families losing would have been 5.4m.

The position after the £600 increase in the personal allowance

The £600 rise in the PA from £5,435 to £6,035 and the corresponding change in the higher-rate threshold give £120 to almost all basic-rate taxpayers (individuals with incomes between £6,635 and £40,835), and give between £0 and £120 to those with incomes between £5,435 and £6,035 or between £40,835 and £41,435. This changes the overall pattern of winners and losers. Together, the abolition of the 10% band, the cut in the basic rate and the £600 increase in the personal allowance mean that:

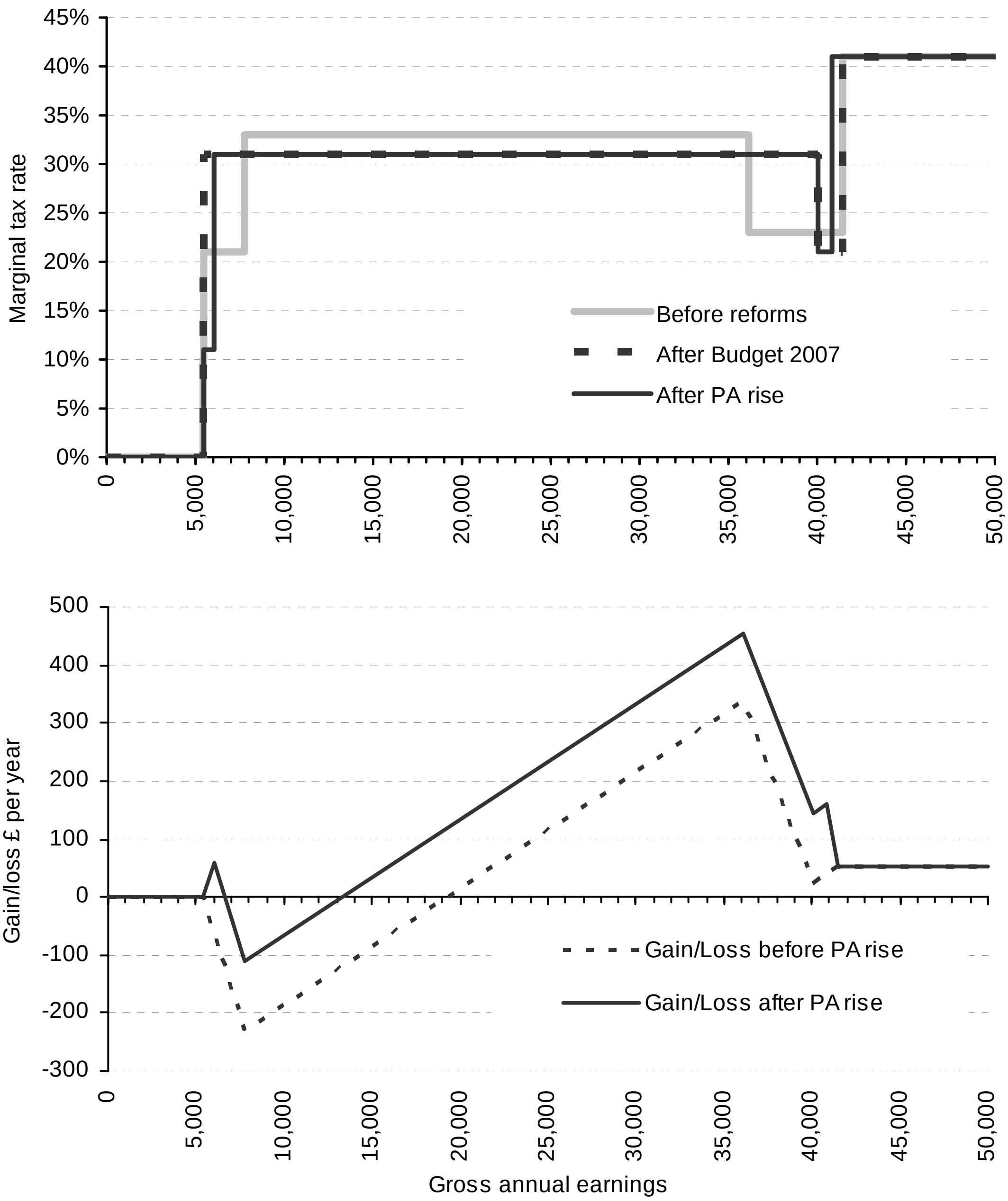
- People aged under 65 with non-savings income between £6,635 and £13,355 are still paying more in income tax than they would have been had none of the changes mentioned above taken place. We estimate there to be around 6m people in this category (although only 2.9m are paying more than £1 a week extra in income tax). The loss is greatest, at £112 a year (equal to the original loss of £232 less the £120 cut in income tax from the rise in the personal allowance), for someone earning £7,755.

- Most people aged 65 or over, and those with non-savings income between £5,435 and £6,635 or between £13,355 and around £40,000, are now paying less income tax. The biggest gain is £457 a year at an income of £36,140.

- Those with incomes above around £40,000 gain very slightly, and will gain even less once the changes to the higher-rate income tax threshold and the National Insurance upper earnings limit announced in Budget 2007 have fully taken effect in 2009–10

Figure 1 shows the main changes graphically.

Figure 1. Income tax and employee NICs in 2008–09



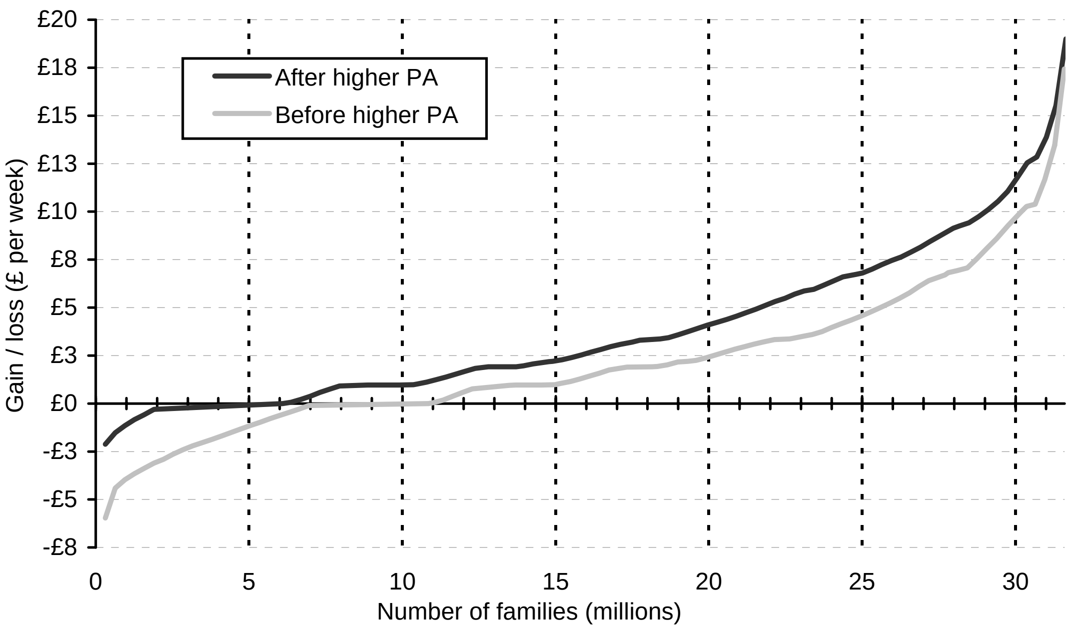
Notes: Assumes no taxable income other than earnings. For simplicity, the marginal rate schedule abstracts from employers' National Insurance contributions and is based upon a worker contracted into the State Second Pension. These make little difference to the gains and losses.
Source: Authors' calculations.

It remains the case that (almost) no individuals aged 65 or more are paying more tax as a result of the reforms, and that the increased generosity of tax credits ensures that single-earner families receiving tax credits are no worse off as a result of the reforms. Furthermore, many of the individuals still paying more income tax may live in families or households with someone who is paying less income tax such that the family (or household) overall does not lose.

After consideration of all the additional measures announced for 2008–09, we now estimate that 0.9m families are still worse off by more than £1 a week from the measures announced in Budget 2007, PBR 2007, Budget 2008 and Finance Bill 2008, and that 21.3m families are better off by more than £1 a week, with 9.4m families broadly unaffected (i.e. seeing a change of £1 a week or less).[8] That so many families gain is hardly surprising given that the set of reforms represents a give-away of £6.3bn.

Figure 2 shows the distribution of families' gains and losses comparing the '2008–09 no reforms' and '2008–09 actual' tax and benefit systems before and after the higher personal allowance. The impact of the higher personal allowance is to make almost 18m families £2.30 a week better off, and this shows up as a near-parallel shift upwards in the distribution of gains and losses.

Figure 2. Cumulative distribution of gains and losses from policies for 2008–09 announced in Budget 2007, PBR 2007, Budget 2008 and on 13 May



Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2005–06 Family Resources Survey.

Table A3 splits the population into 10 family types by age, whether single or couple, and whether the family contains children or not, and shows how the winners and losers are distributed, as well as the average change in income in pounds per week and as a percentage of income, the average gain of the winners, and the average loss of the losers. It shows that:

[8] This is similar to HM Treasury's estimate that the rise in personal allowance reduces the number of losers from 5.3m to 1.1m, although HM Treasury's estimate is at the household level and using a different definition of "losing", as discussed in Box 1. If no-one without children claimed working tax credit, we estimate there would be 1.2m families losing.

- Of the 0.9m families who still lose, 500,000 are single adults without children under 25, 115,000 are single adults aged 25 to 55 without children, and 140,000 are couples where at least one adult is aged 25 to 55 without children. Few are families with children (15,000 losers) or pensioner families (20,000 losers).

- All family types are net beneficiaries, on average, from the reforms. Similarly, all family types are more likely to be winners than losers.

- In proportionate terms, the reforms particularly benefit lone parents and single pensioners, a pattern entirely consistent with the Labour government's tax and benefit changes since 1997.[9]

It should be noted that this analysis would have been considerably different had we examined winners and losers at the household level: although 500,000 single adults without children under 25 have lost by at least £1 a week, almost all of these live in a household with other adults.[10]

Table A2 shows how the winners and losers are distributed across income decile groups, as well as the average change in income in pounds per week and as a percentage of income, the average gain of the winners, and the average loss of the losers. These tables show that:

- The considerable net giveaway implied by Budget 2007, PBR 2007, Budget 2008 and the 13 May announcement is generally worth more (in proportionate terms) to the poor than the rich. However, the pattern is not uniform: the largest gains as a share of income are in the 2nd and 3rd poorest decile groups, and the smallest gains are in the top and bottom decile groups. In cash terms, the top two decile groups are the largest net beneficiaries.

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[9] The cumulative impact of Labour's tax and benefit changes since 1997 up to and including PBR07 has been to increase the average incomes of the poorest tenth of the population by 12% and cut those of the richest tenth by 6%. But, within the poorest tenth, pensioners have gained 24% and families with children 18%, while childless working-age adults have gained only 1%. Indeed, working-age families without children have lost on average from Labour's tax and benefit changes across nine-tenths of the income distribution. Measured as the number of individuals living in households with incomes (adjusted for household size and composition) below 60% of that enjoyed by the average (median) household, poverty has fallen by 600,000 among children, 200,000 among working-age parents and 200,000 among pensioners since 1996–97. But poverty has increased by 500,000 among working age adults without children. All these poverty counts measure incomes before housing costs and are up to 2005–06. Estimates of relative poverty for 2006–07 are due to be released in June 2008.

[10] Indeed, almost all single adults under 25 live in a household with other adults: only 290,000 of the 4.2 million single adults aged under 25 live in a household with no other adults. Of the estimated 450,000 households who lose by more than £1 a week, only 10,000 are single adult households aged under 25.

- Families that lose are more likely to be found towards the bottom of the income distribution than in the middle or the top: 8% of families in decile groups 2 and 12% in decile group 3 are losers, compared with less than 1% of families in decile group 1 and decile groups 7 to 10.

- Families that gain are more likely to be found at the top of the income distribution than at the bottom or the middle: more than 90% of families in decile groups 8 to 10 are winners. Families in the poorest tenth are the least likely to be winners and the most likely to be unaffected: these are families whose incomes are not high enough for them to pay income tax, and who are not receiving child tax credit or winter fuel payments.

- The average loss of the losers is £1.59 a week. The average gain of the winners is £5.68 a week; this tends to be higher for high-income winners than low-income winners.

2.2 The impact of changes due by 2010–11

This section analyses the long-run impact of changes announced in Budget 2007, PBR 2007 and Budget 2008. It does this by comparing:

- **the '2008–09 no reforms' and '2008–09 all reforms' tax and benefit systems.** This shows the effect of all reforms announced in Budget 2007, PBR 2007 and Budget 2008 that will be in place by 2010–11, as if they were implemented now. It essentially looks at whether current government plans will compensate people in the medium run for the abolition of the 10% tax band.

- **the '2008–09 actual' and '2008–09 all reforms' tax and benefit systems.** This shows the likely impact on families of the changes due to take effect between 2008–09 and 2010–11. It is dominated by the removal of the one-off measures for 2008–09.

The medium-run impact of changes announced in Budget 2007, PBR 2007 and Budget 2008

The impact of the income tax changes alone announced in Budget 2007, PBR 2007 and Budget 2008 for 2010–11 is very similar to the position for 2008–09 before the £600 increase in the personal allowance, and was described in the previous section.

Similarly, our analysis of the overall winners and losers from all personal tax and benefit changes announced in Budget 2007, PBR 2007 and Budget 2008 for 2010–11 is also very similar to the position for 2008–09 that existed before the £600 increase in the personal allowance. Other than the reversal of the £600 rise in the personal allowance, the main differences between 2008–09 and 2010–11 are that:

- Additional increases in child benefit, child tax credit, and means-tested benefits for families with children by 2010–11 make it even less likely that families with children lose from the overall set of reforms than in 2008–09.

- The lower level of winter fuel payments makes it more likely that pensioner families are worse off from the overall set of reforms in 2010–11 than in 2008–09.

After considering all the measures announced for 2010–11 in Budget 2007, PBR 2007 and Budget 2008, we estimate that 5.4m families will be worse off by more than £1 a week, that 14.4m families are better off by more than £1 a week, with 11.8m families broadly unaffected (i.e. seeing a change of £1 a week or less).[11]

Table A5 splits the population into 10 family types by age, whether single or couple, and whether or not the family contains children, and shows the how the winners and losers are distributed, as well as the average change in income in pounds per week and as a share of income, the average gain of the winners, and the average loss of the losers. It shows that:

- Of the 5.4m families who will lose, 1.5m are single adults without children under 25, 0.9m are single adults without children aged 25 to 55, and 1.1m are couples without children aged 25 to 55. Very few are families with children (0.6m losers, almost all two-earner couples with children) or pensioner families (0.3m losers).

- All family types will be net beneficiaries, on average, from the reforms, except single adults aged under 25 and couples without children both aged under 25. Similarly, all but those two family types are more likely to be winners than losers.

- In proportionate terms, the reforms will particularly benefit families with children and pensioner families; lone parents are due to see an average rise in net income of 3.8%, and pensioner families a rise of average incomes just over 0.5%.

Table A4 shows how the winners and losers are distributed across income decile groups, as well as the average change in income in pounds per week and as a percentage of income, the average gain of the winners, and the average loss of the losers. This table shows that:

- The considerable net giveaway implied by Budget 2007, PBR 2007 and Budget 2008 and Finance Bill 2008 is generally worth more (as a

[11] If no-one without children claimed working tax credit, we estimate there would be 6.0m families losing.

percentage of income) to the poor than the rich. However, the pattern is not uniform: the largest gains as a percentage of income are in the 2nd and 3rd decile group, and the smallest gains are in the 6th and 7th decile groups. In cash terms, the richest tenth are the largest net beneficiaries on average.

- The families that lose are more likely to be found in the middle of the income distribution than the bottom or the top: 37% of families in decile groups 5 and 32% in decile group 6 are losers, compared with under 6% of families in decile group 10 and 4% in decile group 1.

- Families that win are more likely to be found at the top of the income distribution than the bottom or the middle: over 75% of families in each of decile groups 9 and 10 are winners. Families in the bottom decile group are the least likely to be winners and the most likely to be unaffected: these will be families who do not earn enough to pay income tax, and who are not receiving child tax credit or winter fuel payments.

- The average loss of the losers is £2.78 a week, and this tends to be higher for low-income losers than high-income losers. The average gain of the winners is £6.99 a week; and this tends to be much higher for low-income winners than high-income winners, reflecting the fact that the considerable increase in support for families with children for 2010–11 is strongly targeted on low-income families.

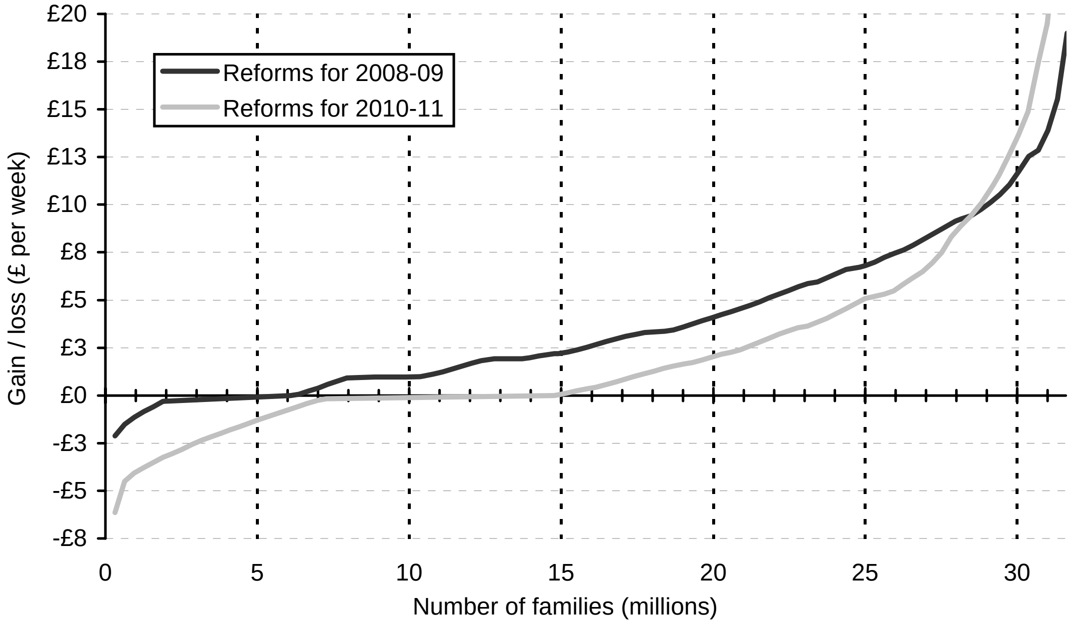
Figure 3 shows the distribution of families' gains and losses under the following two comparisons:

- **the '2008–09 no reforms' and '2008–09 actual' systems**, showing (as in Figure 2) the extent to which the Government has successfully compensated the losers from the abolition of the 10% band in this tax year.

- **the '2008–09 no reforms' and '2008–09 all reforms' systems**, showing the extent to which reforms announced in Budget 2007, PBR 2007 and Budget 2008 provide lasting compensation for the abolition of the 10% band.

It illustrates clearly that far fewer families lose from the reforms implemented in 2008–09, and that they lose by far less, than from the reforms in place by 2010–11, and that far more families gain from the reforms for 2008–09 than from the reforms in 2010–11. The lines cross towards the right-hand side of the Figure because a few families with children are due to gain substantially from the reforms in 2010–11 that will disregard income from child benefit in calculating entitlement to means-tested housing benefit and council tax benefit.

Figure 3. Cumulative distribution of gains and losses from policies announced in Budget 2007, PBR 2007, Budget 2008 and on 13 May



Note: The reforms for 2008–09 lead to 0.9m families being worse off, 21.3m families being better off and 9.4m broadly unaffected. The reforms for 2010–11, assuming the higher personal allowance is not continued, lead to 5.4m families being worse off, 14.4m families being better off and 11.8m broadly unaffected.
Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2005–06 Family Resources Survey.

The impact of changes announced in Budget 2007, PBR 2007, Budget 2008 and on 13 May due to take effect between 2008–09 and 2010–11.

Finally, we compare the actual system in 2008–09 with one that reflects all changes announced in Budget 2007, PBR 2007 and Budget 2008 that will be in place in 2010–11. The change between these two systems includes:

- A £600 cut in the personal allowance and corresponding increase in the higher rate threshold; these leads all basic rate taxpayers to lose up to £120 a year;
- A fall in winter fuel payments;
- A small cut in income tax for higher-rate taxpayers, offset by a slightly larger rise in NICs for the same group;
- An increase in support for families with children.

Overall, we estimate that these changes save the government £1.8bn a year, relative to the position if the 2008–09 system were to be uprated conventionally. But they lead to 18.0m families being worse off, 3.6m families being better off, and 10.0m being broadly unaffected (the group who are 'broadly unaffected' includes most families with someone aged 60 to 79, whose winter fuel payment falls by £50 a year, just under the £1 a week that we classify as a significant change).

Table A7 splits the population into 10 family types by age, whether single or couple, and whether the family contains children or not, and shows the how the winners and losers are distributed, as well as the average change in income in pounds per week and as a share of income, the average gain of the winners, and the average loss of the losers. It shows that:

- Of the 3.6m families who gain, the overwhelming majority are families with children.
- Other than families with children, all family types are net losers, on average, from the changes, and all except families with children are much more likely to be losers than winners.
- In proportionate terms, the changes will particularly benefit lone parent families, who are due to see a rise in average income of 1.5%, and will particularly disadvantage couples without children and single adults under 25, who are due to see a fall in average income of 0.8%.

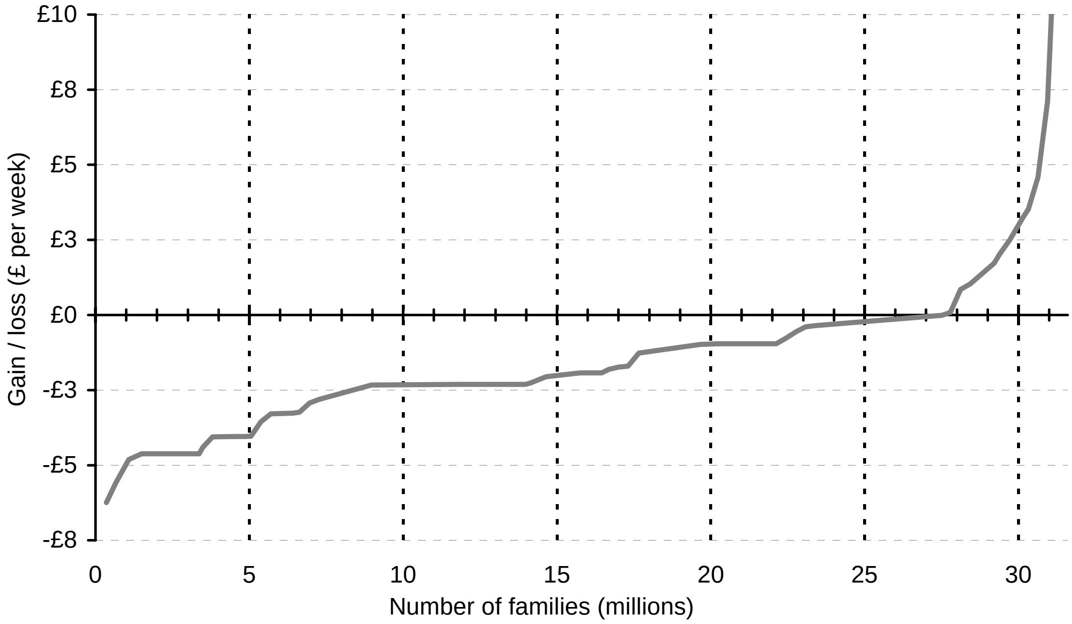
Table A6 shows how the winners and losers are distributed across income decile groups, as well as the average change in income in pounds per week and as a share of income, the average gain of the winners, and the average loss of the losers. The tables show that:

- The poorest three decile groups are due to gain, on average, from the changes between 2008–09 and 2010–11, while the richest 7 decile groups are due to lose on average. The biggest gain is in decile group 2, and the biggest losses are in decile groups 6 to 9. However, it should be noted that, even within the bottom three decile groups, the families who gain are overwhelming likely to be those with children.
- The likelihood that a family loses generally rises as we move up the income distribution: 32% of families in decile group 2 lose, 70% of families in decile group 6 lose, and 85% of families in decile group 9 lose.
- Families that win are more likely to be found at the bottom of the income distribution: around 25% of families in decile groups 2 and 3 are winners.
- Families in the bottom decile group are the most likely to be unaffected: these are families who do not earn enough to pay income tax, and who are not receiving child tax credit or winter fuel payments.

- The average loss of the losers is £2.96 a week, and this tends to be lower for low-income losers than high-income losers. The average gain of the winners is £6.24 a week.

Figure 4 shows the distribution of families' gains and losses. It clearly shows that the vast majority of families will lose from the reforms in place between 2008–09 and 2009–10, with all households containing someone aged 60 or over losing £50 or £100 a year as the winter fuel payments fall, and all basic-rate taxpayers losing £120 a year if the higher personal allowance is not continued.

Figure 4. Distribution of gains and losses from changes announced in Budget 2007, PBR 2007, Budget 2008 and on 13 May due between 2008–09 and 2010–11



Note: The changes between 2008–09 and 2010–11, assuming the higher personal allowance is not continued, lead to 18.0m families being worse off, 3.6m families being better off and 10.0m broadly unaffected.
Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2005–06 Family Resources Survey.

2.3 Conclusion

This section has shown:

- Changes to income tax, national insurance contributions, tax credits and state benefits in Budget 2007, PBR 2007 and Budget 2008 and the higher personal allowance together represent a net tax cut to families of £6.3bn in 2008–09. This represents one of the largest year-on-year giveaways to the household sector through income tax, National Insurance, benefits and tax credits, although other taxes have risen.

- As a result, 21.3m families are better off in 2008–09 than they would have been without any of these announcements, but there remain 0.9m families for whom the tax cuts and increased spending on tax credits and benefits do not compensate for the losses from the abolition of the 10% tax band. Around half of this group are singles under 25, almost all of whom live in households with other families who may be net beneficiaries from the reforms.

- If the higher personal allowance in 2008–09 is assumed to disappear in future years, then there is much less long-term compensation for the abolition of the 10% tax band. By 2010–11, 5.4m families will be worse off as a result of the announcements in Budget 2007, PBR 2007 and Budget 2008. Most of these will be working-age families without children who are not receiving tax credits, either because they are too young, not working full-time, or have too high incomes.

- Not continuing the rise in the personal allowance for 2008–09 and the higher winter fuel payments for winter 2008 will result in all family types except those with children losing from personal tax and benefit changes between 2008–09 and 2010–11 – with around 18m families in total losing more than £1 a week (and many pensioner families losing, but by less). However, the substantial extra spending on families with children announced in Budget 2007, PBR 2007 and Budget 2008 for 2010–11 is set to increase average incomes amongst low-income families with children, as part of the Government's drive to reduce child poverty.

3. Options for 2009–10 and beyond

This section discusses what changes the Government might make to the tax and benefit system in 2009–10 and 2010–11.

The Chancellor's announcement on 13 May said that the higher personal allowance applies to this year, and that he will announce proposals for 2009–10 and beyond in the 2008 Pre-Budget Report.[12] He also said that "for future years our aim is to continue the same level of support for those on low incomes". We explore in section 3.1 how this might be achieved.

But the Government may have other objectives in mind. It might, for example, wish to reduce further the number of losers from the abolition of the10% band. Given that the remaining losers are concentrated amongst adults aged under 25 without children, an obvious response is to extend entitlement to WTC to this group. We explore this in section 3.2.

If the Government wants to keep the higher personal allowance, but seek to remove some of its benefit from those taxpayers who had already been compensated for the abolition of the 10% band, then it might consider a small increase in employee National Insurance contribution rates, or a nominal freeze in income tax personal allowances. If the Government wants to keep the higher personal allowance and re-align the income tax and NIC systems, then it has a number of options, and we discuss all these in section 3.3.

We offer a more general discussion in the final section. We do not discuss policy levers other than taxes and benefits that might be open to the Government when seeking to compensate for the abolition of the 10% tax band, such as increasing the minimum wage.

3.1 Maintaining the same level of support for those on low incomes

In his statement of 13 May, the Chancellor said "for future years our aim is to continue the same level of support for those on low incomes".

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[12] As discussed in section 2, some announcements have already been made for 2009–10 and 2010–11. One of the more problematic ones is the announcement in Budget 2007 that the higher-rate income tax threshold would rise by £800 above inflation in 2009–10, and that the National Insurance upper earnings limit (UEL) would be aligned with it. At the start of 2008–09, the higher-rate threshold was £41,435, and a rise of £800 above indexation would take it to around £42,815 + £800 = £43,615 if the relevant inflation rate were 3.25% (as assumed in Budget 2008). Since then, the higher-rate threshold for 2008–09 has been cut by £600 to £40,835. We assume that, if the higher personal allowance is not continued in 2009–10, then the default assumption is that it will reach £43,615. In scenarios where we assume the government continues with the higher personal allowance, we assume it uprates the current higher-rate threshold and then adds £800, giving a value of £43,035 in 2009–10. However, in both cases we assume that the UEL is set equal to what the higher-rate threshold would have been (£43,615) had there not been a rise in the personal allowance.

If this is understood to mean that no low-income family should see a net tax rise between 2008–09 and 2009–10, then there are two ways to proceed:

- Maintain the higher personal allowance indefinitely. This maintains the same level of support for all basic-rate taxpayers, but at the cost of around £2.7bn a year.

- Replace the higher personal allowance with a starting rate band or allowance whose value was gradually withdrawn ('tapered away') from those with higher incomes. The taper would be equivalent to introducing another tax band with a higher rate applying to. Within this, there are various options:

    - A tapered 10% band (see Box 2) could ensure that there were almost no families losing compared with the 2007–08 system (although compared with the 2008–09 system, individuals with incomes below £6,635 and above £13,355 would pay up to £120 a year more income tax; higher-rate taxpayers would be unaffected). This policy is equivalent to all except the lowest-income tax-payers to a tapered higher personal allowance of £1,160.

    - The Government could taper away the newly-announced £600 increase in the personal allowance (see Box 2). This would not ensure that there were no losers from the abolition of the 10% tax band, but would reduce the cost of the higher personal allowance.

Box 2. A tapered 10% band (or tapered personal allowance)

In this section, we consider a scenario in which the 10% band is reintroduced, but its benefit gradually withdrawn from people with incomes above the end of the 10% band. If the benefit of a 10% band started to be withdrawn as soon as people became basic-rate taxpayers, and if its benefit were withdrawn at a rate of 2p in the pound, then it would ensure that no taxpayers were paying any more income tax as a result of the reforms in and since Budget 2007. In effect, it would be creating a new income tax rate of 22% which applied after the 10% rate but before the 20% rate, giving a 0%, 10%, 22%, 20%, 40% structure.

This policy is equivalent, for all except the lowest-income taxpayers, to a tapered higher personal allowance of £1,160 (which began to be tapered away after incomes reached £7,755 in 2008–09 terms) for which there is a precedent, as this is already done for the extra personal allowance received by individuals aged 65 or over, which is reduced by 50p for each £1 of income above £21,800.

Another option is to withdraw the additional £600 personal allowance so that its benefit disappeared at £19,355 (in 2008–09 terms), the point above which taxpayers gain more from the cut in the basic rate than they lose from the abolition of the 10% tax band. However, we have not modelled this.

The first column of Table 2 estimates how much money (per year) would need to be found in PBR 2008 to implement a tapered 10% band: this is zero in the case where the higher personal allowance disappears. The Table also estimates how much more generous overall the different potential tax and benefit systems for 2009–10 would be than if there had been no changes to the 2007–08 and 2008–09 tax and benefit systems except default indexation. Finally, the Table shows our estimates of the number of losers and winners when comparing these potential systems with both the 2007–08 and 2008–09 systems.

For example, the second row of the table shows that, if the personal allowance was not continued in 2009–10, then no money would need to be found in PBR 2008. However, as section 2.2 showed, there would be 18.1m families losing compared with 2008–09, and 5.4m families losing compared with 2007–08.

Table 2. Costs, and number of winners and losers of options for 2009–10 and beyond

	How much would need to be found in PBR 2008? (£m/yr)	*Cost (£m/yr)*	*Number of losers*	*Number of winners*	*Cost (£m/yr)*	*Number of losers*	*Number of winners*
		(relative to uprated 2007–08)			*(relative to uprated 2008–09)*		
Memo:							
Actual 2008–09	n/a	£6,340	0.9m	21.3m	n/a	n/a	n/a
PA not continued	£0	£4,450	5.4m	14.4m	-£1,890	18.1m	3.4m
Without £300 cut in WTC threshold:							
Maintain higher PA	£2,750	£7,200	1.1m	18.8m	£860	3.0m	4.5m
Tapered 10% band	£1,850	£6,300	0.1m	16.6m	-£40	11.9m	7.0m
With £300 cut in WTC threshold:							
Maintain higher PA	£2,450	£6,900	1.1m	18.8m	£560	3.7m	3.9m
Tapered 10% band	£1,550	£6,000	0.1m	16.5m	-£340	12.9m	5.9m

Note: Numbers of winners and losers counts families seeing changes of £1 a week or more. A negative cost means increased revenue for the government. PA = personal allowance.
Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2005–06 Family Resources Survey.

Maintaining the personal allowance would require the Government to find just over £2.7bn a year (in today's prices), but it would keep the number of losers from the abolition of the 10% tax rate to around a million, and it would mean only 3.0m families losing in 2009–10 relative to 2008–09 (mostly pensioner households in which someone is aged 80 or more; repeating the higher winter fuel payments, which would reduce the number of families losing in 2009-10 compared with 2008-09 down to 0.9m, would cost an additional £575m a year).

The tapered 10% band would cost £1.85 billion, £900m a year less than the higher personal allowance. It would ensure that almost no family is paying more tax as a result of income tax changes in and since Budget 2007. However, there would be 11.9m losers compared with a tax system that had kept the higher personal allowance of 2008–09. And, as we discuss in section 3.4, it would also re-complicate the structure and administration of income tax.

Implementing either of these policies would enable the Government to undo some of its existing compensation to low income families without leaving them worse off than they were before the abolition of the 10p rate (although they would be worse off than they are this year). Specifically, given that Budget

2007 announced a rise in the WTC threshold which compensated one-earner families on tax credits for the abolition of the 10% band, the Government could undo some of that increase and still ensure that such families had been compensated from the abolition of the 10% band. If the Government continued with higher personal allowance, it could cut the WTC threshold by around £300 a year, which would save the Government around £0.3bn a year (assuming full take-up of WTC). If it implemented the tapered 10% band, it could conceivably save a little more from WTC. Doing this would have no effect on the number of losers in 2009–10 from the abolition of the 10% band, but would create more losers compared with the 2008–09 system.

3.2 Extending WTC entitlement to others without children

Section 2 showed that the losers from the abolition of the 10% band are almost all families not receiving tax credits, whether because they are not entitled through being under 25 or not working 30 or more hours a week, or having too high an income, or through non-take-up. It also showed that, of the remaining 0.9m families who lose even after the higher personal allowance, around half are single adults under 25 without children.

We therefore look in this section at three reforms that extend entitlement to tax credits to three new groups:

- those aged 21 to 24 working at least 30 hours a week;
- those aged 25 or over working 16-29 hours a week;
- those aged 21 or over working at least 16 hours a week.

Table 3 shows the cost of these measures and the impact on the number of losers, with and without the higher personal allowance alongside.[13] All estimates assume full take-up; it would be reasonable to assume that take-up would be much lower than this, and that this would affect both the cost and the impact on the number of losers.

Assuming full take-up, extending the WTC to those aged 21-24 would cost around £0.4bn and would reduce the number of losers by 100,000 (if done on top of the higher personal allowance) or 300,000 (if done instead). Doing this in addition to extending WTC to those working 16-29 hours would cost around £1bn with full-take-up. If done alongside the higher personal allowance, it would reduce the number of losers by 300,000; it done instead of the higher personal allowance, it would reduce the number of losers by 600,000.

[13] We assume that those under 25 would have the same entitlement as those 25 or over, but the Government could decide to have a lower rate for those aged 21-25; this would clearly reduce the cost.

Table 3. Costs, and number of winners and losers of options for 2009–10 and beyond

	How much would need to be found in PBR 2008? (£m/yr)	*Cost (£m/yr)*	*Number of losers*	*Number of winners*	*Cost (£m/yr)*	*Number of losers*	*Number of winners)*
		(relative to uprated 2007–08)			*(relative to uprated 2008–09)*		
Actual 2008–09	n/a	£6,340	0.9m	21.3m	n/a	n/a	n/a
Maintain higher PA	£2,750	£7,200	1.1m	18.8m	£860	3.0m	4.5m
Plus							
WTC to 21+	£3,130	£7,580	1.0m	19.2m	£1,240	3.0m	4.9m
WTC to 16 hrs+	£3,200	£7,650	1.0m	19.2m	£1,310	3.0m	4.9m
WTC to 21+ and 16 hrs+	£3,790	£8,240	0.8m	19.7m	£1,910	3.0m	5.4m
Stop higher PA	£0	£4,450	5.4m	14.4m	-£1,890	18.1m	3.4m
Plus							
WTC to 21+	£290	£4,840	5.1m	14.7m	-£1,500	17.8m	3.7m
WTC to 16 hrs+	£450	£4,900	5.2m	14.7m	-£1,440	17.8m	3.7m
WTC to 21+ and 16 hrs+	£1,050	£5,500	4.8m	15.2m	-£840	17.5m	4.2m

Note: Numbers of winners and losers counts families seeing changes of £1 a week or more. A negative cost means increased revenue for the government. PA = personal allowance.
Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2005–06 Family Resources Survey.

3.3 Recouping some of the cost of the higher personal allowance or re-aligning income tax and National Insurance contributions

This section discusses other changes to income tax and NICs that the Government could make.

If the Government wants to keep the higher personal allowance, but seek to recoup some of the cost by removing some of its benefit from those taxpayers who had already been compensated for the abolition of the 10% band, then it might consider a small increase in employee NIC rates, or a nominal freeze in the income tax personal allowances. Both of these save the Government money, but clearly neither is strictly consistent with the Chancellor's objective "to continue the same level of support for those on low incomes" as both would lead to low income families' being worse off in 2009–10 than under an uprated 2008–09 system:

- Freezing the new higher personal allowance is equivalent to a real cut of around £200 a year, and so unwinds about a third of the policy announced on 13 May.[14] It would therefore represent a £40 a year tax rise for basic-rate tax-payers. It would recoup some money from those who had not lost from the abolition of the 10p rate in the first place, but would also mean that fewer of those who had lost would be fully compensated. Freezing the personal allowance (with an offsetting adjustment to the basic-rate band so that higher-rate tax-payers were unaffected) would reduce the cost to the Exchequer from around £2.7bn this year to £1.8bn in 2009–10.

- A rise of 0.3 percentage points in the main rate of employee NICs would leave someone at the UEL just over £110 worse off, thereby offsetting almost all of the £120 benefit of the higher personal allowance. Those on lower incomes would be affected by less. This change would, though, lead to fewer families being compensated for the abolition of the 10% band. Like freezing the income tax allowance, this would recoup about £900m of the approximately £2.7bn cost of maintaining (and uprating) the 2008–09 personal allowance.

On the other hand, one of the aims of the 2007 Budget, and of earlier Gordon Brown budgets, was to align income tax allowances and thresholds with those for National Insurance contributions. The points at which income tax and NICs become payable have been aligned since 2001–02, and the 2007 Budget announced that the higher-rate income tax threshold would be aligned with the upper earnings limit for NICs from 2009–10. That alignment has been undone entirely by the £600 rise in the personal allowance (and the corresponding cut in the higher-rate threshold) in 2008–09. If the Government wishes to continue with the higher personal allowance or something similar, and to re-align the two systems, then it has a number of options, including:[15]

- Increase the earnings threshold (the point at which employee and employer NICs become due) to the new, higher, income tax personal allowance, and lower the UEL to the new higher-rate threshold. This is effectively a cut in NICs.

- Freeze the personal allowance (with an offsetting adjustment to the basic-rate band so that higher-rate tax-payers are unaffected), and then align the earnings threshold with it, and align the UEL with the higher-

[14] So if the Government continued to freeze the higher personal allowance, by 2011–12 it would reach the same level is if it had just been routinely uprated in line with inflation since 2007–08.

[15] If the Government does not continue with the higher personal allowance then, barring any other surprises in the PBR 2008, income tax and NI thresholds will be aligned in 2009–10, as announced in Budget 2007.

rate threshold. This would increase income tax bills but reduce NICs for basic-rate taxpayers.

Table 4 contains more details. If the new higher personal allowance were frozen, then the number of losers from the abolition of the 10% band would rise to 2.2m; alternatively, a small rise in the rate of employee NICs would make this figure 1.5m. Freezing the personal allowance would mean there would be 8.3m losers, and increasing NICs 9.6m losers, in 2009–10 relative to 2008–09, compared with 3.0m if neither of these happened and the higher personal allowance were maintained and conventionally uprated (many additional families would lose by less than £1 a week, which we count as being broadly unaffected).

Aligning the NICs earnings threshold with a maintained and uprated higher personal allowance would be extremely effective at removing losers from the abolition of the 10% band (the number would fall to 0.3m[16]), but at an additional cost over and above that of maintaining the higher personal allowance of £1.5bn in employee NICs and £1.8bn in employer NICs – thus more than doubling the cost in total.[17] Lastly, freezing the personal allowance but increasing the NI earnings threshold to it is more costly than only indexing the personal allowance (because of the extra employer NICs revenue lost) but does lead to more families being winners.

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[16] Our calculation of winners and losers assumes that families do not benefit from a cut in employer NICs. We suspect that the public might find it hard to accept that they had been compensated for the abolition of the 10% band if the Government compensated them by cutting employer NICs. However, in the long-run, wages should adjust to make the impact of employer NICs the same as that of employee NICs, so whoever benefits from a cut in one would also benefit from a cut in the other (furthermore, in the long-run, it is likely that employers will recoup some of the benefit from both lower income tax and NI).

[17] The Government could, of course, recoup some of the lost employer NICs revenue with a small rise in its rate.

Table 4. Costs, and number of winners and losers of options for 2009–10 and beyond

	How much would need to be found in PBR 2008? (£m/yr)	*Cost (£m/yr)*	*Number of losers*	*Number of winners*	*Cost (£m/yr)*	*Number of losers*	*Number of winners)*
		(relative to uprated 2007–08)			*(relative to uprated 2008–09)*		
Actual 2008–09	n/a	£6,340	0.9m	21.3m	n/a	n/a	n/a
PA not continued	£0	£4,450	5.4m	14.4m	-£1,890	18.1m	3.4m
Maintain higher PA	£2,750	£7,200	1.1m	18.8m	£860	3.0m	4.5m
Do not align IT and NI							
Freeze PA	£1,870	£6,320	2.2m	17.4m	-£20	8.3m	4.4m
Raise NI by 0.3ppts	£1,830	£6,280	1.5m	17.7m	-£60	9.6m	4.3m
Align IT and NI							
Align IT and NI	£4,210 (+£1,760 emp NI)	£8,660 (+£1,760 emp NI)	0.3m	21.1m	£2,330 (+ £1,490 emp NI)	2.2m	17.6m
Freeze PA and align IT and NI	£3,010 (+ £1,310 emp NI)	£7,460 (+ £1,310 emp NI)	1.4m	19.4m	£1,120 (+ £1,050 emp NI)	4.1m	6.8m

Notes: Numbers of winners and losers counts families seeing changes of £1 a week or more; note that freezing the personal allowance costs most individuals around £40 a year. A negative cost means increased revenue for the government. Our calculation of winners and losers assumes that families do not immediately benefit from a cut in employer NICs. In the long-run, wages adjust to make the impact of employer NICs the same as that of employee NICs. IT = income tax; PA = personal allowance; emp NI = employer National Insurance contributions.
Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2005–06 Family Resources Survey.

4 Conclusion

This section has set out a number of options the Chancellor may be considering as he puts together PBR 2008 (when he is due to make announcements for 2009–10). The attractiveness or otherwise of these options, of course, depend upon what the Government is trying to achieve. Inferring this – and what relative importance it places on its different objectives – is not easy.

The originally stated objectives of Budget 2007 were to simplify the income tax and NICs system – which we applauded at the time (while pointing out the inconsistency of retaining the 10% band for savings income) and to lower the basic rate of income tax. It was the decision to fund the latter by doing the former that has created losers from what was a giveaway personal tax package overall.

The stated objective of the 13 May announcement on personal allowances was to compensate most of the low-income losers from the abolition of the 10p rate and to provide additional support to middle income families who are suffering a squeeze on their living standards from rising prices.[18] A third, unspoken, objective of both Budget 2007 and the 13 May announcement was to avoid either big gains or big losses for higher-rate taxpayers.

As the Government is now discovering to its cost, it is very expensive to bring about structural changes to income tax and NICs if you are constrained not to inflict losses either on low-income families or on higher-rate taxpayers. By borrowing to finance part of the reform, the cost is simply being pushed onto an as yet unidentified group of taxpayers in future years. Added to the Government's partial U-turn on capital gains tax, the events of the last 18 months do not bode well for the prospects of structural tax reform.

But given this, what can we say about the policies examined in this section?

- The 13 May announcement will compensate most of the low-income losers from the abolition of the 10p tax rate in 2008–09. But by doing so in a way that has also paid money to millions of middle-income families that did not lose in the first place, the Government finds itself in a position where a large number of families will lose out next year and beyond if this 'one-off' giveaway disappears. It therefore seems highly implausible that the Treasury can begin planning the tax system for 2009–10 with a blank sheet of paper; the increased personal allowance for 2008–09 is likely to be the baseline from which planning will start. A similar argument could be made regarding the 'one-off' higher winter fuel payments for winter 2008, although some past one-off increases in WFPs have turned out to be just that.

- If the Government is willing to inflict losses next year on the middle-income families that are benefiting from the increase in the personal allowance this year, the cheapest way for the Chancellor to achieve his goal of maintaining the current level of support for the low-income beneficiaries would be to taper the personal allowance (or taper a re-introduced 10% band) – equivalent to increasing the basic rate of income tax from 20% to 22% on incomes between £7,755 and £19,355 in the current tax system. This would cut the cost of the increase in the allowance by about a third, from around £2.7bn this year to £1.8bn next year. But it is hard to imagine how an income tax rate structure of 0%, 20% (or 10%), 22%, 20%, 40% could be justified on economic efficiency grounds. Such a complication of the income tax system would also make it more costly to administer and

[18] In fact, the tax and benefit system already provides support to families as prices rise, as income tax allowances and many state benefits and tax credits are increased in line with various measures of inflation.

comply with, and considerably harder for individual taxpayers to understand. It would be ironic indeed if a set of tax reforms originally designed to reduce the number of income tax bands from three to two ended up increasing it to four with no underlying economic rationale.

- Two other options that would reduce the cost of the increase in the personal allowance by about a third would be to freeze it in nominal terms at its 2008–09 level of £6,035 or to increase modestly employees' National Insurance contribution rates. These would do less to recomplicate the tax system than the tapered band, but they would mean that 1.3m and 0.6m (respectively) more families would no longer be fully compensated from the abolition of the 10p rate than in 2008–09.

- Extending eligibility for WTC to younger and part-time workers without children could fully compensate some of those who are still losing from the abolition of the 10p rate, even after the increase in the personal allowance. Relative to the cost involved, such measures would do little to reduce the number of losers remaining from the abolition of the 10% band if the higher personal allowance is made permanent, and yet they are certainly not comprehensive enough to appear to be a viable alternative. Furthermore, with take-up of WTC so low, it cannot be wise to rely on tax credits as a way of compensate reliably for losses in income tax. Such a reform would be of considered benefit to those families who gain eligibility to WTC and successfully claim it, and these tend to be low-income families. It would also strengthen incentives to work for the same group, although increase the number facing high marginal effective tax rates. On the other hand, it would reverse the decisions made by the Government when it introduced WTC for those without children in 2003, and argued that an age limit was needed, because younger adults tended to experience only transitory low pay, and that it was reasonable to expect adults with neither dependent children nor a long-term health issue to work full-time.

- The backdated rise in the personal allowance has undone Gordon Brown's efforts to align income tax and NICs thresholds. Should he extend the higher personal allowance, then bringing the NI earnings threshold up to match it (and aligning the NI upper earnings limit with the higher-rate income tax threshold) would cost another £2.7bn (approximately) a year, although this would be extremely effective in compensating almost all the remaining losers from the abolition of the 10% tax band. Freezing the personal allowance and adjusting NI thresholds to match would leave low earners' combined income tax and employee NICs bills broadly unchanged, but would lose the Government £1.3bn in revenue from employer NICs.

Table A1. List of measures included in the analysis

Effective from when	Announced when		
	Budget 2007	*PBR 2007*	*Finance Bill 2008 (Budget 2008+ 13 May announcement)*
2008–09	Abolish 10% income tax band for all except savings income Cut basic rate of income tax from 22% to 20% Increase UEL by £75 above inflation to £770 Increase PA for those aged 65+ by £1,180 above inflation to £9,030 (£9,180 for 75+) Increase child element of CTC by £150 above earnings indexation [NB subsequently superseded] Increase WTC threshold by £1,200 to £6,420 Raise tax credit withdrawal rate to 39%	Increase child element of CTC by further £25 above earnings indexation [ie £175 total] to £2,085	£50 more for 60-79s and £100 more to 80+ in WFP as one-off. £600 rise in PA (and cut in HRT) as one-off
2009–10	Increase HRT by £800 above inflation Increase UEL to align with HRT	Child maintenance disregards in IS set at £20	CB for first child to reach £20 Increase child element of CTC by £50 above earnings indexation
2010–11	CB for first child to reach £20 [NB subsequently superseded]	Increase child element of CTC by £25 above earnings indexation Child maintenance disregards in IS set at £40	Disregard CB in HB/CTB means test

Notes: UEL = National Insurance upper earnings limit; PA = income tax personal allowance; HRT = income tax higher rate threshold; CTC = child tax credit; WTC = working tax credit; CB = child benefit; IS = income support; HB = housing benefit; CTB = council tax benefit; WFP = winter fuel payment

Table A2. Actual 2008–09 vs uprated 2007–08, decile group analysis

Income decile group	*Total increase in income (ie Exchequer cost), £m/year*	*Losers*	*Winners*	*Little change*	*Average change, £ per week*	*Change, % of net income*	*Average loss of losers, £ per week*	*Loss of losers, % of net income*	*Average gain of gainers, £ per week*	*Gain of gainers, % of net income*
Poorest	93	25,167	306,868	2,827,106	0.57	0.7	-1.63	-1.1	5.74	3.0
2	500	250,015	1,514,445	1,395,267	3.04	1.5	-1.72	-1.2	6.22	2.5
3	634	385,133	1,958,560	815,590	3.86	1.5	-1.48	-0.9	6.34	2.2
4	534	82,229	1,928,368	1,147,930	3.25	1.2	-1.8	-0.7	5.32	1.7
5	436	129,141	1,750,766	1,278,812	2.66	0.8	-1.5	-0.5	4.66	1.3
6	462	44,423	2,233,252	881,148	2.81	0.8	-1.67	-0.5	3.84	1.0
7	580	11,838	2,780,274	367,857	3.53	0.8	-1.52	-0.4	3.95	0.9
8	797	5,298	2,939,023	215,060	4.85	0.9	-1.38	-0.2	5.17	1.0
9	1,141	8,164	2,998,574	151,120	6.95	1.1	-2.4	-0.3	7.29	1.1
Richest	1,160	7,603	2,853,543	297,514	7.07	0.6	-1.51	-0.1	7.73	0.6
All	6,340	949,011	21,263,673	9,377,404	3.86	0.9	-1.59	-0.7	5.68	1.1

Note: Income decile groups are derived by dividing all families into 10 equal-sized groups according to income adjusted for family size using the McClements equivalence scale. There are approximately 3,160,000 families in each decile group. Winners and losers are those seeing changes of £1 a week or more. See text for details and key assumptions.

Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2005–06 Family Resources Survey.

Table A3. Actual 2008–09 vs uprated 2007–08, family type analysis

Family type	*Cost*	*Total*	*Losers*	*Winners*	*Little change*	*Average change, £ per week*	*Change, % of net income*	*Average loss of losers, £ per week*	*Loss of losers, % of net income*	*Average gain of gainers, £ per week*	*Gain of gainers, % of net income*
Single <25, no kids	70	4,218,602	500,835	699,667	3,018,100	0.32	0.2	-1.52	-0.9	3	0.9
Single 25-55, no kids	638	5,165,638	114,325	2,840,287	2,211,026	2.37	0.7	-1.58	-0.8	4.27	0.9
Single 55-SPA, no kids	134	1,141,369	46,121	524,759	570,489	2.25	0.7	-1.49	-0.9	4.73	1.0
Couple both <25, no kids	72	527,110	39,633	307,468	180,009	2.62	0.6	-1.62	-0.6	4.66	0.8
Couple 25-55, no kids	1,060	4,123,796	142,607	3,380,856	600,333	4.95	0.7	-1.87	-0.5	6.08	0.8
Couple both 55-SPA, no kids	392	1,681,653	71,057	1,233,229	377,367	4.49	0.8	-1.65	-0.5	6.11	0.9
Couple with kids	1,918	5,340,304	13,201	4,966,643	360,460	6.91	1.0	-1.91	-0.3	7.39	1.1
Lone parent	748	1,940,307	0	1,930,106	10,201	7.42	2.3	–	–	7.45	2.3
Single pensioner	625	4,429,084	10,773	3,125,892	1,292,419	2.71	1.1	-1.08	-0.7	3.48	1.2
Couple, at least one over SPA	681	3,022,225	10,459	2,254,766	757,000	4.33	1.0	-1.41	-0.4	5.53	1.1
All	6,340	31,590,088	949,011	21,263,673	9,377,404	3.86	0.9	-1.59	-0.7	5.68	1.1

Notes: SPA = state pension age. Winners and losers are those seeing changes of £1 a week or more. See text for details and key assumptions.
Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2005–06 Family Resources Survey.

Table A4. 2010–11 vs uprated 2007–08, decile group analysis

Income decile group	*Total increase in income (ie cost to HMT), £m/yr*	*Losers*	*Winners*	*Little change*	*Average change, £ per week*	*Change, % of net income*	*Average loss of losers, £ per week*	*Loss of losers, % of net income*	*Average gain of gainers, £ per week*	*Gain of gainers, % of net income*
Poorest	135	117,979	278,363	2,762,799	0.82	1.1	-2.51	-1.8	10.54	5.3
2	683	500,784	1,066,421	1,592,522	4.16	2.1	-3.24	-2.1	13.85	4.9
3	755	597,612	1,436,103	1,125,568	4.59	1.8	-3.52	-1.8	11.52	3.7
4	442	770,481	1,241,221	1,146,825	2.69	1.0	-3.07	-1.3	8.67	2.6
5	241	1,172,912	1,037,242	948,565	1.47	0.5	-2.68	-1.0	7.43	2.0
6	149	1,000,732	1,075,955	1,082,136	0.91	0.2	-2.48	-0.7	5.12	1.2
7	193	583,549	1,163,685	1,412,735	1.17	0.3	-2.61	-0.5	4.43	0.9
8	340	292,861	1,897,455	969,065	2.07	0.4	-2.04	-0.3	3.69	0.7
9	648	165,214	2,709,592	283,052	3.95	0.6	-2.73	-0.3	4.76	0.7
Richest	866	201,377	2,463,011	494,272	5.27	0.4	-2.14	-0.2	6.96	0.5
All	4,451	5,403,501	14,369,048	11,817,539	2.71	0.6	-2.78	-0.8	6.99	1.2

Note: Income decile groups are derived by dividing all families into 10 equal-sized groups according to income adjusted for family size using the McClements equivalence scale. There are approximately 3,160,000 families in each decile group. Winners and losers are those seeing changes of £1 a week or more. See text for details and key assumptions.
Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2005–06 Family Resources Survey.

Table A5. 2010–11 vs uprated 2007–08, family type analysis

Family type	*Cost*	*Total*	*Losers*	*Winners*	*Little change*	*Average change, £ per week*	*Change, % of net income*	*Average loss of losers, £ per week*	*Loss of losers, % of net income*	*Average gain of gainers, £ per week*	*Gain of gainers, % of net income*
Single <25, no kids	-186	4,218,602	1,542,810	254,982	2,420,810	-0.85	-0.5	-2.73	-1.4	2.9	0.7
Single 25-55, no kids	236	5,165,638	862,274	1,859,639	2,443,725	0.88	0.3	-2.12	-0.9	3.46	0.6
Single 55-SPA, no kids	49	1,141,369	217,634	337,794	585,941	0.83	0.3	-2.45	-1.2	4.4	0.8
Couple both <25, no kids	-25	527,110	239,573	113,614	173,923	-0.91	-0.2	-3.47	-0.9	3.2	0.5
Couple 25-55, no kids	326	4,123,796	1,097,180	2,101,819	924,797	1.52	0.2	-3.15	-0.6	4.64	0.5
Couple both 55-SPA, no kids	113	1,681,653	544,002	720,120	417,531	1.29	0.2	-3.3	-0.8	5.52	0.7
Couple with kids	1,954	5,340,304	563,947	4,038,960	737,397	7.04	1.0	-2.47	-0.4	9.63	1.4
Lone parent	1,251	1,940,307	1,924	1,923,880	14,503	12.4	3.8	-1.88	-0.3	12.5	3.9
Single pensioner	290	4,429,084	166,396	1,486,275	2,776,413	1.26	0.5	-2.83	-1.4	3.88	1.1
Couple, at least one over SPA	445	3,022,225	167,761	1,531,965	1,322,499	2.83	0.6	-2.99	-0.8	5.83	1.0
All	4,451	31,590,088	5,403,501	14,369,048	11,817,539	2.71	0.6	-2.78	-0.8	6.99	1.2

Notes: SPA = state pension age. Winners and losers are those seeing changes of £1 a week or more. See text for details and key assumptions.
Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2005–06 Family Resources Survey.

Table A6. 2008–09 vs 2010–11, decile group analysis

Income decile group	*Total increase in income (ie cost to HMT), £m/yr*	*Losers*	*Winners*	*Little change*	*Average change, £ per week*	*Change, % of net income*	*Average loss of losers, £ per week*	*Loss of losers, % of net income*	*Average gain of gainers, £ per week*	*Gain of gainers, % of net income*
Poorest	31	187,420	222,698	2,749,753	0.19	0.2	-2.13	-1.5	4.75	2.4
2	158	1,021,329	797,394	1,340,015	0.96	0.5	-2.25	-1.4	7.64	2.6
3	135	1,211,590	822,867	1,123,968	0.82	0.3	-2.38	-1.1	7.54	2.1
4	-91	1,608,426	488,851	1,061,779	-0.55	-0.2	-2.44	-0.9	6.02	1.5
5	-183	1,979,063	299,836	880,392	-1.11	-0.3	-2.66	-0.8	7.91	1.8
6	-310	2,204,890	147,394	806,563	-1.89	-0.5	-2.9	-0.8	6.57	1.5
7	-382	2,421,250	76,228	661,881	-2.33	-0.5	-3.07	-0.7	7.54	1.4
8	-458	2,632,408	59,583	467,171	-2.79	-0.5	-3.37	-0.6	6.52	1.0
9	-493	2,727,524	72,865	358,762	-3	-0.4	-3.48	-0.5	2.72	0.3
Richest	-294	2,097,908	397,583	662,697	-1.79	-0.1	-3.12	-0.3	2.61	0.2
All	-1886	18,091,808	3,385,299	10,112,981	-1.15	-0.3	-2.96	-0.6	6.45	1.3

Note: Income decile groups are derived by dividing all families into 10 equal-sized groups according to income adjusted for family size using the McClements equivalence scale. There are approximately 3,160,000 families in each decile group. Winners and losers are those seeing changes of £1 a week or more. See text for details and key assumptions.
Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2005–06 Family Resources Survey.

Table A7. 2008–09 vs 2010–11, family type analysis

Family type	*Cost*	*Total*	*Losers*	*Winners*	*Little change*	*Average change, £ per week*	*Change, % of net income*	*Average loss of losers, £ per week*	*Loss of losers, % of net income*	*Average gain of gainers, £ per week*	*Gain of gainers, % of net income*
Single <25, no kids	-256	4,218,602	2,134,469	7,802	2,076,331	-1.17	-0.8	-2.29	-1.0	2.98	0.2
Single 25-55, no kids	-402	5,165,638	3,372,688	48,918	1,744,032	-1.5	-0.4	-2.29	-0.7	3.44	0.5
Single 55-SPA, no kids	-84	1,141,369	649,708	45,646	446,015	-1.42	-0.4	-2.47	-0.8	2.59	0.3
Couple both <25, no kids	-97	527,110	463,790	-	63,320	-3.53	-0.8	-3.99	-0.8		
Couple 25-55, no kids	-734	4,123,796	3,715,965	39,984	367,847	-3.42	-0.5	-3.82	-0.5	3.31	0.2
Couple both 55-SPA, no kids	-280	1,681,653	1,386,213	52,266	243,174	-3.2	-0.5	-3.93	-0.7	3.27	0.2
Couple with kids	36	5,340,304	3,075,607	1,499,404	765,293	0.13	0.0	-3.2	-0.4	7.13	1.6
Lone parent	503	1,940,307	134,435	1,461,068	344,804	4.98	1.5	-1.84	-0.4	6.85	2.2
Single pensioner	-335	4,429,084	2,009,621	105,934	2,313,529	-1.46	-0.6	-2.22	-0.9	2	0.2
Couple, at least one over SPA	-236	3,022,225	124,277	1,748,636	-1.5	-0.3	-2.81	-0.6	2.5	0.2	-236
All	-1886	31,590,088	18,091,808	3,385,299	10,112,981	-1.15	-0.3	-2.96	-0.6	6.45	1.3

Notes: SPA = state pension age. Winners and losers are those seeing changes of £1 a week or more. See text for details and key assumptions.
Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2005–06 Family Resources Survey.