The Institute for Fiscal Studies

ELECTION BRIEFING 2001

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FISCAL REFORM AFFECTING HOUSEHOLDS, 1997 - 2001

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IFS Election Briefing Note No. 5
May 2001

Funding

We would like to thank the Economic and Social Research Council (www.esrc.ac.uk) for supporting this work through funding for the ESRC Centre for the Microeconomic Analysis of Fiscal Policy (Grant number M544285002).

This document is published on the IFS website, www.ifs.org.uk/election/index.shtml (May 2001).

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Fiscal reforms affecting households, 1997–2001

This government has introduced many tax and benefit reforms that directly affect families, such as changes to income tax, the benefit system and excise duties. This Election Briefing Note reviews these, before assessing how their effect has varied between different groups of the population. Election Briefing Note 4 examines changes to overall living standards, which largely reflect things outside government control, but this Briefing Note looks at the effect of tax and benefit policy in isolation. Another difference from Election Briefing Note 4 is that we are able to assess Labour's full term here.

1. The scope of the analysis

We analyse here only those fiscal reforms whose effect can be directly assigned to individual households, such as changes to income tax, benefits and excise duties. The total absolute level of structural change in all taxes and benefits since May 1997 has been over £71bn, but only 55% of this (£39bn) falls within our scope here. The remaining changes have largely affected companies. Of course, such reforms will ultimately affect individuals, as only people can be made worse or better off by tax changes, but determining precisely who will eventually feel the effects would be complex and uncertain. A few changes to taxes directly paid by households are also excluded from the main analysis, chiefly because we are unable to model them. These reforms are dealt with separately in Section 4.

The modelled reforms comprise measures that have reduced household incomes by £15bn, but offsetting these are others which have increased household incomes by around £24bn. This means that, overall, households have gained (and the exchequer lost) by around £8.5bn as a result of the measures considered. The corporate tax and other measures that we have excluded from our analysis have, by contrast, seen the exchequer gain. The overall net effect of structural changes in all taxes and benefits thus involves a smaller give-away than the reforms that we have modelled in isolation. This means that the results we obtain in this Election Briefing Note will overstate the eventual average gain to households resulting from government policy. Table 1 shows the budgetary effects of the modelled changes.

Table 1. Budgetary effect of major fiscal reforms affecting households

	Positive budget effect	Negative budget effect
Income tax		
Married couple's allowance	£3,070m	
Company cars: fuel scale charges	£365m	
Company cars: high business mileage reduction	£260m	
Income tax rates and personal allowances		–£6,020m
Children's tax credit		–£2,660m
National Insurance		
Employee contributions	£645m	–£3,300m
Self-employed contributions, net effect of reforms	£240m	
Indirect taxes		
VAT on domestic fuel		–£535m
Tobacco taxation	£1,765m	
Road fuel duties	£4,830m	–£840m
Alcohol taxation		–£125m
Insurance premium tax	£300m	
Vehicle excise duty reforms		–£320m
Spending		
Mortgage interest relief at source	£3,130m	
Working families' tax credit		–£2,870m
Child benefit and income support child premiums		–£3,055m
Abolition of lone-parent rate in child benefit	£390m	
Abolition of lone-parent means-tested benefit rates	£210m	
Income support child premium for 18-year-olds reduced to 17-year-old rate	£15m	
Increase in earnings disregard for income-related benefits to £20		–£20m
Pensioners' package (winter allowance, basic pension and minimum income guarantee increases)		–£3,870m
Sure Start maternity grant and increases in maternity allowance		–£250m
Total	**£15,220m**	**–£23,865m**

Notes: All costings have been adjusted to 2001–02 prices. Benefit reductions for lone parents differ from other changes in that their full budgetary effect applies only after several years – the cut is phased in for existing claimants, only immediately fully applying for new claimants. The effects of the reduced high business mileage discount in company car taxation will not show up in the modelled results in Section 3 as the model's input data are inadequate to determine who is affected. A number of long-term changes to benefits for sick and disabled people and widows are excluded. Some taxes were reformed more than once over the Parliament, which means that they may score as both exchequer gains and exchequer losses.
Sources: The IFS tax and benefit model, TAXBEN, run on 1997–98 Family Expenditure Survey data, used to evaluate abolition of lone-parent rates in means-tested benefits and child benefit, and also the reduction in income support child premium for 18-year-olds. For all other measures, HM Treasury, Financial Statement and Budget Report, various years.

2. The pattern of tax reform

This section outlines the modelled changes, first to direct tax and then to indirect tax. This Parliament's changes in transfer payments (including the working families' tax credit) will be discussed separately in Election Briefing Note 11.

Direct tax reform

The most important income tax reforms in the current Parliament were announced in the 1999 Budget. Most notably, these were: the 10% starting rate, the 1p cut in the basic rate to 22%, the abolition of mortgage interest relief at source (MIRAS) and the replacement of the married couple's allowance with the children's tax credit. Although announced simultaneously, implementation dates of the different measures varied.

Table 2. Selected personal tax changes announced 1997–2001

Reform	Who gains/loses?	Annual gain/loss
Married couple's allowance abolished for people born after 1935	Losers: married couples with at least one taxpayer	£310.50 maximum loss applies to all married higher-rate and nearly all basic-rate taxpayers.
Replacing 20% with 10% starting income tax rate	Gainers: individuals with income above £4,535	Maximum £188 gain applies if income is £6,415. Gain rises from zero to £188 over £4,535–£6,415 income range. Gain falls back to £44 over £6,415–£9,335 income range. £44 gain for all with incomes above £9,335.
Basic rate cut 1p to 22%	Gainers: individuals with income above £6,415	Higher-rate taxpayers: £275.20 gain. Basic-rate taxpayers: gain between zero and £275.20, depending (positively) on income.
Children's tax credit for children aged 1–16	Gainers: families including children and taxpayers where no individual income exceeds £41,735	Basic-rate taxpayers: £520 gain (unless tax bill is smaller than this, in which case income tax set to zero). Higher-rate taxpayers with income below £41,735: gain between zero and £520, depending (negatively) on income.
Children's tax credit for children under 1	Gainers: families including children and taxpayers where no individual income exceeds £49,535	Basic-rate taxpayers: £1,040 gain (unless tax bill is smaller than this, in which case income tax set to zero). Higher-rate taxpayers with income below £49,535: gain between zero and £1,040, depending (negatively) on income.
Employee National Insurance: 'entry fee' abolished and primary earnings threshold raised	Gainers: all earning above £72 per week	£153 gain for all earning over £87 per week. Gain between £75 and £153, depending (positively) on earnings, where weekly earnings are £72-£87.
Employee National Insurance: upper earnings limit up to £575	Losers: anyone earning above £525 per week	£260 loss per year for all earning over £575 per week. Loss varies positively with earnings in range £525–£575.
MIRAS abolished	Losers: all mortgage-holders	Maximum £315 loss where outstanding mortgage exceeds £30,000. Otherwise, gain varies (positively) with mortgage.

Notes: All reforms evaluated once fully effective. Evaluation derived by comparison with the Spring 1997 tax system, adjusted only for inflation. Interactions between reforms and benefit payments are ignored. Starting tax rate calculations are for a single adult with no special tax credits or allowances. MIRAS calculation assumes mortgage rate of 7%. National Insurance changes assume adult is 'contracted into' SERPS.

In one sense, New Labour's direct tax changes have been consistent with the direction of tax reform in the 1980s: the emphasis has been on reducing the main tax rates (as the introduction of the 10% rate and the basic-rate reductions imply) while decreasing the generosity of the 'fringes' of the tax system (for example, in company car reform and the abolition of MIRAS). But in spite of the emphasis on untargeted reductions in the headline tax rates, some direct tax reforms have been designed to be progressive. This is perhaps most evident in the National Insurance reforms, but also in the decision to divert the children's tax credit away from the highest-income families.

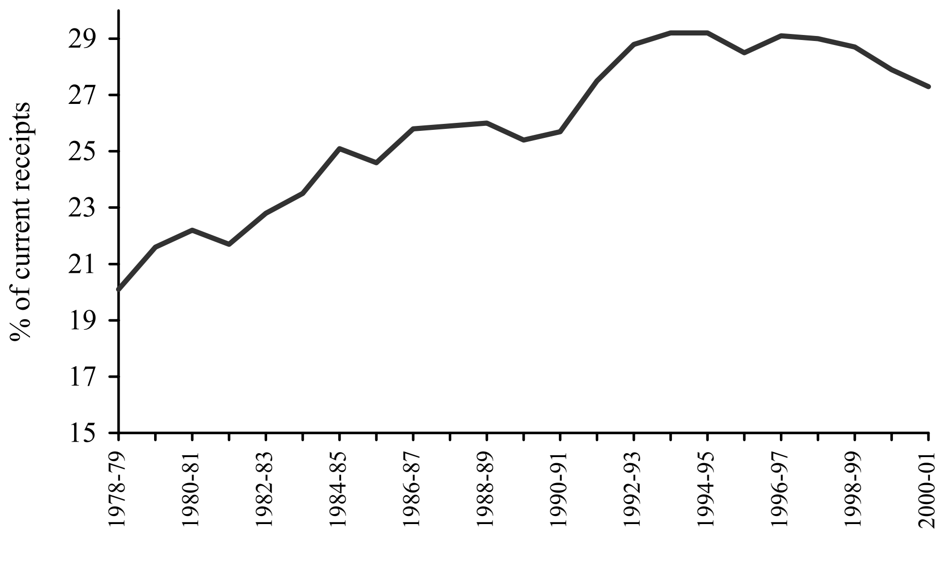
Table 2 charts the most important changes and explains who gained and lost from them and by how much.

Indirect tax reform

Trends in indirect tax revenue

From 1979 to 1997, the Conservatives altered the balance of taxation from direct to indirect. For example, the 1979 Budget cut basic-rate income tax from 33% to 30%, but increased the main VAT rate from 8% to 15%. Other VAT increases followed, as did sharp increases in duties on tobacco and petrol. Figure 1 shows indirect tax revenue as a fraction of total tax receipts since 1978–79.[1] The increasing reliance on indirect taxes until the mid-1990s is clear. But it is also clear that the trend has been somewhat reversed since 1997, in spite of the much-publicised increase in petrol duties. The main rate of VAT, the most important indirect tax, was left unchanged, and there was even a cut in VAT on some items.

Figure 1. Indirect tax revenue as a share of total tax receipts



Source: HM Customs and Excise, *Annual Report*, various years.

[1] Indirect tax revenue defined here as excise duties on alcohol, hydrocarbon oil, tobacco, betting and gaming, air passenger duty, insurance premium tax, vehicle excise duty and VAT.

Petrol tax and other excise duties

1993 saw the introduction of automatic annual increases – 'escalators' – in excise duty on both petrol (introduced at 3% above inflation and then increased to 5% above inflation later that year) and cigarettes (3% above inflation). At the time of the 1997 election, the Conservative government was still operating these escalators, and Labour moved to increase them sharply on gaining power. In its Summer 1997 Budget, Labour strengthened both commitments: real annual rises of 6% for fuel and 5% for cigarettes were announced, and in some years increases exceeded even these percentages.

The position on petrol today is very different. The public now faces a choice between a Labour government that has recently *cut* fuel duty, a Conservative Party pledged to reduce petrol prices by a further 3p and the Liberal Democrats, who are pledged to no real-term fuel duty increases until 2005. The policy reversal, which politicians of all parties seem to have engaged in, was first effective in the Spring 2000 Budget, when the Chancellor abandoned the automatic escalators and froze petrol duty. The following autumn saw the fuel crisis, and in its wake the policy reversal went even further.

Labour's abandonment and then reversal of its earlier policy of increasing petrol duties has now been important enough to mean that the average increase in total unleaded petrol tax in this Parliament (3.2% per year) is now only around half the average increase in the last (6.1%), as Table 3 shows. The table also gives a clue as to why this reality may not accord with perceptions. The pre-tax price of petrol was falling sharply under the last government; under the present administration, it has risen. The overall effect has been that the final unleaded price has risen by an average 3.0% per year under Labour, which is very similar to the 3.1% annual average experienced under the Conservatives.

Table 3. Average changes in excise duty over the last two Parliaments

	1992–97 Average annual real increase in …			**1997–2001** Average annual real increase in …		
	pre-tax price	**total tax**	**retail price**	**pre-tax price**	**total tax**	**retail price**
Unleaded petrol	–4.1%	6.1%	3.1%	2.5%	3.2%	3.0%
Beer	2.3%	–0.3%	1.5%	0.6%	0.1%	0.5%
Wine	0.0%	–0.1%	–0.1%	–1.5%	–0.1%	–0.8%
Spirits	4.6%	–2.5%	–0.1%	0.2%	–1.4%	–0.8%
Cigarettes	4.5%	6.1%	5.8%	1.1%	5.5%	4.6%

Notes: Unleaded petrol duty for March 2001 is taken at the ultra-low sulphur petrol rate. March 2001 prices for all goods assume that there has been no change in the pre-tax price since January 2001. For details of actual duty rates in the last 25 years or so, see the IFS website, http://www.ifs.org.uk/taxsystem/contentstax.shtml.
Sources: Typical prices for beer, wine and spirits taken from HM Customs and Excise, *Annual Report 1998/9*, The Stationery Office, London, 1999. Typical prices for unleaded petrol and cigarettes taken from Office for National Statistics, *Consumer Price Indices*, The Stationery Office, London, March 2000.

Perhaps an additional reason why the very high tax rises on petrol were considered politically acceptable in the years from 1993 to the end of the 1990s was that motorists were, at that time, converting from leaded to unleaded petrol, which enabled them to enjoy a tax cut on their petrol. In

1992, only 50% of motorists normally bought unleaded petrol, but, by 1997, 75% of motorists were using it.[2] By 2000, the conversion to unleaded was all but complete, ensuring that any petrol duty rises were felt in full by all motorists.

The 2001 Budget saw the first inflation-only increase in cigarette tax in years, confirming the end of the escalator era. This may partially have reflected increasing concern about the growth in smuggling. Estimates of revenue lost in total from cross-Channel smuggling of tobacco increased from £680m in 1996 to £1,035m in 1999.[3] In the March 2000 Budget, the government announced an anti-smuggling strategy and allocated £209m over three years to reduce this growth in tobacco smuggling. But in spite of the real-terms freeze in the 2001 Budget, real tax on cigarettes has risen sharply under Labour, by an annual average of 5.5%. In the last Parliament, the average was slightly higher, at 6.1%.

During both 1992–97 and 1997–2001, real taxes on alcohol did not increase in the manner of those on cigarettes and petrol. Real taxes on beer and wine were broadly stable, and the real tax on spirits fell.

3. Effect of reforms on household incomes

The reforms announced since 1997 that will be effective by the end of June 2001 have, on average, increased household disposable incomes by 2.7%.[4] But gains have been far from evenly distributed. Indeed, Table 4 shows that, while 36 million adults have seen gains in household post-tax income, almost 8 million have lost from the reforms.

Table 4. Adults affected by reforms introduced between July 1997 and June 2001

Number of adults in households:	Reforms affecting disposable income	Reforms to VAT and duties	Overall effect of reforms
- gaining	38.1 million	11.3 million	36.1 million
- unchanged	2.1 million	0.1 million	<0.1million
- losing	3.7 million	32.6 million	7.8 million

Source: TAXBEN run on 1997–98 Family Expenditure Survey data.

Figure 2 shows how the average effect has differed across the income distribution. The figure shows separately the effects of, first, all reforms effective during the financial year 2001–02 and, second, all measures announced to be effective by April 2003. Structural changes, such as the proposed pension credit and the integrated child credit, are ignored in these results as we do not yet know precisely how they will work. The (mostly)

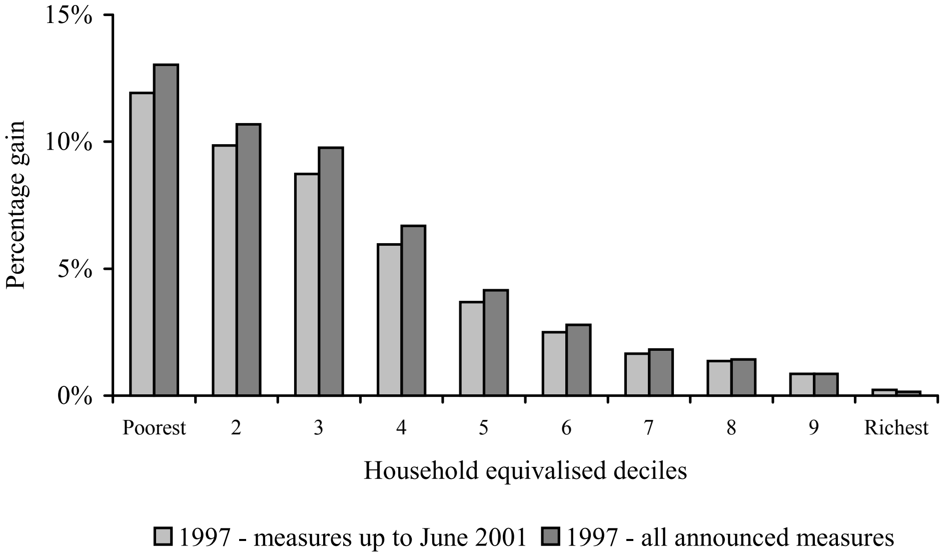
[2] *Transport Statistics Great Britain 1999 Edition*, The Stationery Office, London, 1999.

[3] HM Customs and Excise, 'Tackling tobacco smuggling', http://www.hmce.gov.uk/general/latest/index.htm.

[4] Source: TAXBEN run on 1997–98 Family Expenditure Survey data.

long-term reforms to benefits for widows and sick and disabled people are also ignored.

Figure 2. Effect of major fiscal reforms announced since July 1997, by decile



Notes: Deciles are constructed by dividing UK households into 10 equal-sized groups, ranked by income adjusted for family size. The first decile contains the poorest 10% of the population, while the tenth decile contains the richest 10%.
Source: TAXBEN run on 1997–98 Family Expenditure Survey data.

The major differences between the two sets of measures are: the planned basic state pension increase in April 2002; the higher minimum income guarantee in 2002 and 2003; the children's tax credit addition for babies; and further increases to the fuel scale charges applied in company car taxation.

The figure shows clearly that gains have been disproportionately concentrated at the lower end of the income distribution, a result consistent with the government's aim of reducing relative poverty amongst target groups, notably pensioners and children. Once all announced measures are effective, the incomes of the poorest 10% should rise by around 13%, while those of the next poorest (deciles 2 and 3) should rise 10%. In contrast, average proportional gains amongst the top half of the income distribution are much smaller, less than 3% for each of the top five deciles.

The substantial average gains at the bottom end are mainly a result of higher means-tested benefits. Some workless families (notably pensioners and those families with children) have seen sharp increases in entitlement. Low-paid workers with children have received extra state support through the working families' tax credit. But non-take-up of means-tested support means Figure 2 (which is based on the assumption of 100% take-up) overstates the true effect on low-income families. The government has estimated that, for example, 5–12% of income support entitlement and 21–27% of family credit (the forerunner of the working families' tax credit) goes unclaimed.[5] This gives a very rough guide to the likely scale of the extent to which notional gains (which assume 100% take-up) overstate actual income changes.[6]

But there have been other progressive measures on top of means-tested benefit increases. On the benefit side, the increased state pension and child benefit rates deliver an equal cash gain to all eligible families which is worth most in proportional terms to the poorest. Relatively low earners have proportionally gained most from National Insurance reforms. Some tax changes have also been progressive. For example, the children's tax credit has been targeted away from the best-off, while the net effect of National Insurance reforms has been to increase the contributions of the highest-paid households while reducing everyone else's. At the same time, certain tax increases – notably changes to petrol duty and company car tax – have fallen most heavily on better-off households.

Some income tax reforms, however, have been much less targeted. The introduction of the 10% band delivered gains to all taxpayers, and the 1p reduction in the basic rate to 22% overwhelmingly benefited the top third of the income distribution. It is these measures that have ensured, on average, that even the top 10% of families have gained from the reforms overall.

On average, then, Labour's complex package of reforms leaves all income groups better off. Once we consider all modelled measures due to take effect by 2003, families in the bottom decile gain an average of £13.15 per week, while even the richest gain an average of £1.10. But such summary statistics mask the full picture, for while some households have seen more substantial gains, others, in all parts of the income distribution, have lost out. Figure 3 illustrates this, showing the *fraction* of families in different parts of the income distribution that have gained or lost by different amounts.

The progressive nature of the measures remains clear. Over 50% of households in the bottom half of the income distribution have seen their net income rise by more than £10 per week; in contrast, fewer than 14% of the top decile experienced the same. Some 9% of households in the richest 10% of the population have seen their post-tax incomes fall by more than £10 per week, something almost no families (1% or less) in each of the bottom five income deciles suffered.

But it is also clear that large numbers of families at all income levels have experienced smaller, but non-trivial, losses, of between £1 and £10 per week. In the poorest decile, 22% of families are in this position, as are around 10–25% of families in all other income deciles.

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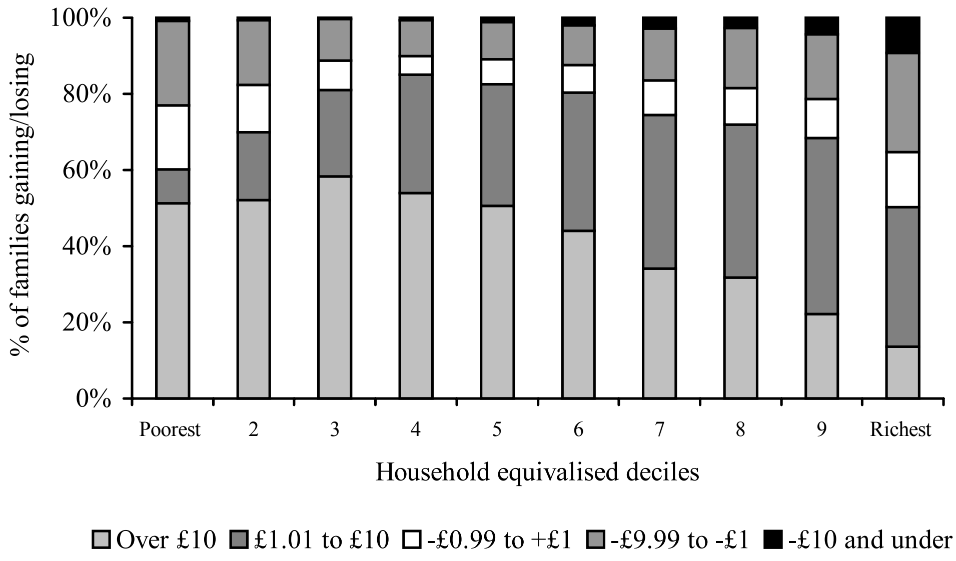
[5] DSS, 'Income related benefits estimates of take up, 1998/99', 2000, http://www.dss.gov.uk.

[6] Election Briefing Note 11 discusses the extension of means testing more fully.

Figure 3. Gainers and losers by income group from all announced reforms



Source: TAXBEN run on 1997–98 Family Expenditure Survey data.

So losers are to be found across the income distribution, in spite of the overall progressive nature of the reforms. Losses at the bottom end follow from Labour's use of revenue-raising measures on the household sector that are not directly related to income. Rather, tax increases have related to family characteristics, such as being married, being smokers or being drivers. Some of these characteristics, such as being drivers, are more common in high-income households. In such cases, the corresponding tax rise is progressive overall but still creates low-income losers, because, for example, some low-income families do drive extensively. Other relevant characteristics, such as cigarette smoking, are, if anything, negatively related to income, making for a regressive tax increase which creates low-income losers.

Further, where Labour has given money through higher benefits to low-income families, it has not done so indiscriminately but rather has singled out families with children and pensioners for most of the largesse. As a result, poorer families who do not fall into either group have not faced any changes on the benefit side to compensate them for any losses through the revenue-raising measures. This discrimination between different types of families is strongly evident in Table 5, which shows how average incomes of different types of family have been affected by all Labour's announced tax and benefit measures. Rises in income have been far more substantial for those with children and for pensioners than for everyone else.

Families with children gained variously from the working families' tax credit, the children's tax credit, higher child benefit and increased income support child allowances. Thus each of the four family types with children gains, on average, more than £10 per week. Two-earner couples with children gain slightly less than lone parents and single-earner couples as they are less likely to benefit from higher benefits. Workless couples with children have gained most, by an average of £20.50 per week.

Table 5. Average weekly gains by family type, for all announced measures

Family type	Average weekly gain
Families with children	
Single-parent family	£15.00
No-earner couple with children	£20.47
Single-earner couple with children	£17.41
Two-earner couple with children	£12.51
Pensioners	
Single pensioner	£15.13
Pensioner couple	£14.23
Others	
Single, not employed	£0.76
Single employed	£2.83
No-earner couple without children	£2.61
Single-earner couple without children	–£0.68
Two-earner couple without children	£2.05

Source: TAXBEN run on 1997–98 Family Expenditure Survey data.

Pensioners' substantial gains chiefly reflect the state pension increase, sharply increased means-tested benefits and the introduction of the winter fuel payment. Pensioners were also protected from certain tax rises, notably in the continuation of the married couple's allowance for those born before 1935. On average, a single pensioner household has gained £15.15 and a pensioner couple £14.25 per week.

Compared with pensioners and those with children, all other family types have fared far less favourably. For these remaining family types, direct tax cuts have been very largely offset by the abolition of MIRAS, the end of the married couple's allowance and higher indirect taxes. Still, most have gained, but by less than an average of £3 a week in every case. Single-earner couples without children stand out as the only group to have experienced an average loss, albeit a small one.

4. Other taxes directly paid by households

Since 1997, there have been changes to some taxes that are directly paid by households in addition to the changes we have modelled. This section reviews these. Most of these taxes are those that it is impossible for us to model because of inadequate data, notably stamp duty and capital gains tax.

Council tax

Local taxation was excluded from the main analysis on the grounds that its specific rates are set by councils, not the national government whose policies we are reviewing. But council tax rates are set to raise the revenue that local authorities require over-and-above that from the central government grants that provide the bulk of their finance. The government, through its decision about the size of these grants, thus shares responsibility for the level of council tax rates, making it interesting to consider how inclusion of the tax alters our analysis of Labour's first term.

The council tax has increased substantially since April 1997, continuing a trend evident in the preceding three years. On average, rates in England and Wales have risen by 19%, even after adjusting for inflation.[7] This increase leaves the average household losing out by 90p each week; this reduces the average household gain from all the modelled measures that Labour has announced from £8.90 to £7.98 each week.

In distributional terms, the council tax is regressive, taking a bigger share of lower incomes. But council tax benefit ensures most of the poorest families are protected from the tax increase, so rising tax rates actually affect them very little. In proportional terms, the biggest net effect is in the middle of the income distribution, but the effect is not dramatic: average gains in the fifth income decile drop back from 4.1% to 3.8%. Proportionally, the council tax is less of a burden on the richest, but council tax increases are just sufficient to convert the small average gain (£1.10 a week) that households in the top decile would otherwise have experienced from Labour policies into a small average loss (55p a week). All other deciles continue to gain on average.[8]

Stamp duty

Stamp duty on more expensive houses was increased in each of the first four Labour Budgets. Before these increases, the tax was levied at the single rate of 1% on all property over £60,000. The 1997 Budget introduced higher rates on more expensive properties, and it is these higher rates that have since been increased. By April 2000, the rates had reached their current levels, shown in Table 6. By 2001, these tax increases were yielding the government £1.8bn per year, equivalent to an increase of more than half a penny on the basic rate of income tax.

Table 6. Rates of stamp duty on land and buildings

Property value	Pre-reform rate	Post-reform rate
<£60,000	0%	0%
£60,000–£250,000	1%	1%
£250,000–£500,000	1%	3%
>£500,000	1%	4%

The tax increase on some transactions has been very substantial. Tax on, say, the purchase of a property worth £600,000 has increased from 1% to 4%, implying an additional cost of £18,000.

Since we cannot model stamp duty, we cannot say with any precision how this tax increase is borne between different types of family. But as the extra payments are confined to people buying properties of over £250,000, it seems likely that most of the impact will fall on those with high incomes. It is also very likely that more families living in London and the South-East will be affected than elsewhere because of higher property prices in these regions: in

[7] IFS calculation based on information from CIPFA.

[8] Source: TAXBEN run on 1997–98 Family Expenditure Survey data.

London in 1999, for example, the average dwelling sold cost 59% more than the average across England and Wales.[9]

Capital gains tax (CGT)

The March 1998 Budget announced a major reform of CGT. Indexation – the discounting of capital gains that merely compensated for inflation – was abolished. At the same time, CGT rates were selectively cut. Previously, CGT was charged at the individual taxpayer's marginal income tax rate – 40% for a higher-rate taxpayer. After the reform, the rate charged declines gradually from 40% as an asset is held over time. After 10 years, a minimum rate applies. For 'business assets', this minimum rate is 10%; for other assets, the minimum rate is 24%. Budget 2000 extended the preferential treatment of business over other assets: it announced a faster taper for business assets, so that the minimum CGT rate applied after just four years.

In total, the government estimates it is forgoing £450m a year as a result of these changes.[10] The aim of the reform was to encourage long-term investment, rather than to redistribute in favour of particular types of individuals, but this was also a consequence. Gains are restricted to CGT payers, a group of just 130,000 individuals and 24,000 trustees in 1997–98, the most recent year for which data are available. CGT payers tend to be relatively well off: no individual pays CGT unless they have reaped a gain in excess of £7,500 in a single year. In addition to having capital gains, most of those paying the tax have significant incomes: in 1997–98, nearly half had sufficiently high incomes to pay higher-rate income tax.[11]

As CGT payers are a relatively small group, the tax cut represented by this reform would be substantial even if it were distributed evenly amongst them. But the gain from the reform is unevenly distributed amongst CGT payers: those owning businesses and those who hold assets for long periods will fare best; and those with larger gross capital gains pay more CGT and so will also have experienced greater cash benefits where their tax rate declines. For a small group of individuals with large capital gains on business assets, the benefits of the reform will have been very substantial indeed.

5. Employer National Insurance reform

We have focused on reform of taxes that *directly* affect individual households, such as taxes on their incomes and purchases. Other taxes, such as corporation tax, have been ignored because we cannot be sure how their burden is shared between different families. But Labour has reformed one 'business' tax that can be analysed in the same way as the main personal tax changes – employer National Insurance (ENI). Economic theory suggests this should eventually affect workers' net incomes in the same way as employee contributions, for

[9] Source: Table 6.11, *Regional Trends*, 2000 edition, The Stationery Office, London.

[10] Parliamentary question. Treasury reference: 1050N 00/01; 14 March; reference number 153714; answered on 14 March 2001.

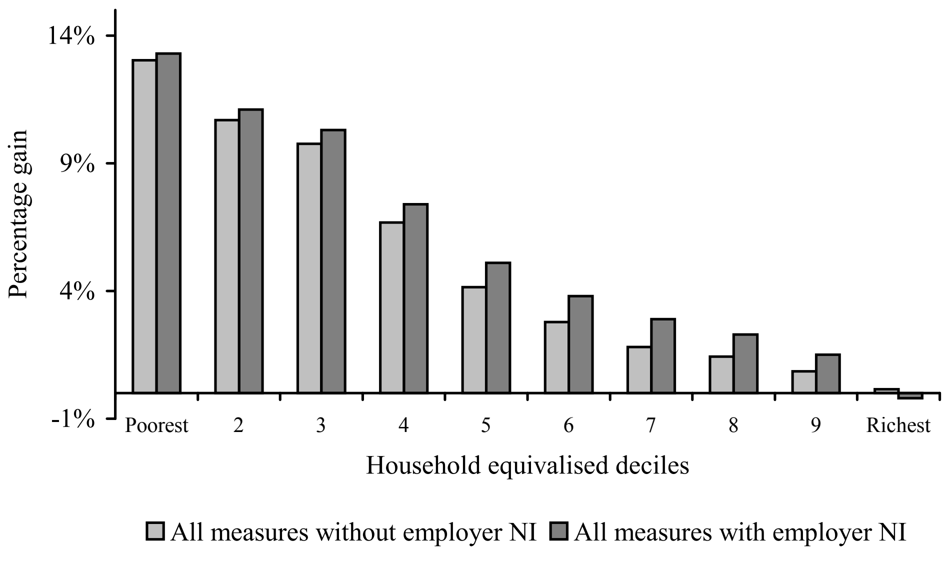
[11] Source: *Inland Revenue Statistics*, 2000.

both taxes introduce an equivalent gap between the cost to an employer of hiring a worker and the employee's take-home pay. If a worker's ENI increases, although her net pay does not immediately fall, the increased expense of employing her might be expected to reduce her next pay rise, and will thereby eventually reduce her net income.

So Labour's ENI reforms can be included in our analysis, under the economists' assumption that they will ultimately bear on families in the same way as taxes that they pay more directly. The reforms largely represented a simplification of the old system, aimed at removing labour market distortions.[12] But their implementation was also used to redistribute liabilities: the previously relatively heavy burden on low-paid jobs was relieved while that on the higher-paid was increased. Labour has made one further reform – a general reduction in ENI, designed to offset exactly the revenue raised by the climate change levy, a business tax that we do not attempt to model.

Figure 4 repeats the numbers from Figure 2 that show the full effect of all Labour's announcements. They are then shown a second time, with households' gains or losses recalculated to include the change in the ENI liability to which they give rise. Including ENI does give a fuller picture of the effects of the reform, but it must be stressed that, even once ENI reforms are included, the results remain incomplete, in that the effects of Labour's other substantial business tax changes are still not being assigned to families.

Figure 4. Effect of Labour's reforms, including employer National Insurance, across the income distribution



Source: TAXBEN run on 1997–98 Family Expenditure Survey data.

[12] See A. Dilnot and C. Giles (eds), *The IFS Green Budget: January 1998*, IFS, London, pp. 38–43, for a discussion of the distortions in the pre-reform National Insurance system.

There is a relatively modest impact on the lower income deciles as relatively few amongst them are earning sufficiently to be paying National Insurance at all. All other deciles below the top see their gains extended. By contrast, the top 10% of families have been made worse off by the reform. ENI reform cuts their incomes by 0.4%. This effect is sufficient to reverse our previous conclusion, that the top 10% had gained very slightly from Labour policy. Ignoring ENI the group gained by an average of 0.2%; once it is included they lose out by 0.2%.

6. Conclusions

Labour has reformed the tax and benefit system extensively. The overall results have been progressive – the poorest families have gained substantially, principally because of higher benefits. Low-income families with children and pensioners have fared especially well. Overall, the reforms have given money away, so big gains at the bottom of the income distribution have proved compatible with more modest average gains even for the better-off, at least before taxes that are not formally paid by households – such as employer National Insurance – are considered But there have been losers, and, because Labour's reforms have been based partially on family characteristics other than income, these are found in all parts of the income distribution.