Tax and Benefit Reforms Under Labour

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David Phillips

Series editors: Robert Chote, Carl Emmerson and Luke Sibieta
Tax and benefit reforms under Labour

James Browne and David Phillips

Summary

- Tax and benefit changes implemented between May 1997 and April 2010 represent a net ‘takeaway’ from the public or a boost to the government’s finances of £7.1 billion, costing each household about £270, on average, in 2010–11, relative to the conventional ‘unchanged policy’ baseline the Treasury uses in Budgets and Pre-Budget Reports.

- The £7.5 billion ‘giveaway’ in Labour’s first term and the £6.4 billion ‘takeaway’ in its second were highly progressive relative to this same ‘unchanged policy’ baseline, significantly reducing the incomes of richer households and increasing those of poorer ones. The £8.1 billion takeaway in Labour’s third term comes mostly from the richest households, with the incomes of the rest little changed on average.

- Labour’s measures have particularly benefited low-income families with children and pensioners receiving tax credits or means-tested benefits.

- Over time, the Treasury’s ‘unchanged policy’ baseline would imply an ongoing increase in the average tax rate and an ongoing fall in the value of benefits and tax credits relative to overall living standards. This suggests that a more meaningful definition of ‘unchanged policy’ would be one in which tax thresholds and allowances, and benefits and tax credit levels, rise in line with national income rather than prices. Judged against this benchmark, and assuming that the net revenue from ‘fiscal drag’ from taxes that are difficult to assign to particular households (such as corporation tax, stamp duties and business rates) is zero, Labour’s measures constitute a much larger ‘takeaway’ of £36.4 billion (around £1,400 per household or 4.7% of net household income) in 2010–11. They also appear slightly less progressive.

- Labour’s tax and benefit reforms have, on average, slightly weakened both the incentive to work at all and the incentive for workers to increase their earnings. In particular, Labour’s reforms have weakened the incentive for couples with children to have two earners rather than one and have increased the number of workers with marginal effective tax rates of 70% or more. However, Labour’s reforms have strengthened the incentive to work at all, and the incentive to increase earnings, for some of those who had the weakest incentives in 1997, such as lone parents.

- Policy reforms since 1997 have had a mixed record in reducing distorting differences in the tax treatment of different forms of saving. Tax-free savings vehicles have been expanded, and tax relief for mortgage interest for homeowners has been abolished. But Labour’s capital gains tax reforms have reduced the attractiveness of investing in shares outside an ISA or pension fund when only nominal capital gains are accrued, and encouraged small business owners to invest in their own businesses.

- Note that we do not consider reforms that have been announced by the current government to come into effect after the general election. Those measures, and alternatives proposed by the Conservative Party and the Liberal Democrats in their manifestos, will be analysed in a subsequent Election Briefing Note.
1. Introduction*

This Election Briefing Note describes the main tax and benefit reforms since 1997, and shows how they have affected total government revenues. It then goes on to discuss the impact of these reforms on the distribution of income between household types, on work incentives and on the incentive to save. A subsequent Election Briefing Note will examine how Labour’s reforms have affected the so-called ‘couple penalty’ that exists in the tax and benefit system. This Briefing Note supersedes analysis last produced in Phillips (2008),1 by taking into account all reforms that are in effect in April 2010.

2. The main tax and benefit reforms since 1997

Estimates of the effect of the main tax and benefit reforms since 1997 on the public finances are shown in Table 2.1. We can see that Labour’s reforms have increased revenues by £7.1 billion compared with what they would have been under an ‘unchanged’ 1997 system. This is revenue that could then be used to increase spending on public services or to lower government borrowing. This relatively small figure is the difference between a large set of revenue-raising changes (raising £108.1 billion) and a large set of giveaways (costing £101.0 billion). As we shall see in Section 3, this means that, although the net takeaway has been small, the measures have had a significant effect on the distribution of income between households. Comparing total effects in each parliament, the net effect of measures implemented before 2001 is a giveaway of £7.5 billion, those implemented between 2001 and 2005 represented a net takeaway of £6.4 billion and those implemented since 2005 have represented a net takeaway of £8.1 billion. We now go on to discuss the main measures highlighted in the table in turn.

Notes and Source to Table 2.1

a. The 10p ‘starting’ rate replaced the 20p ‘lower’ rate that applied over a wider range of income. The cost of lowering the marginal tax rate on the first portion of taxable income was partially offset by increasing the marginal tax rate from 20p to 23p slightly higher up. This is why the cost of introducing the 10p rate was significantly lower than the revenue raised from abolishing it.
b. Includes landfill tax, aggregates levy, climate change levy and air passenger duty.
c. Includes betting and gaming duties, insurance premium tax and other customs duties and levies.
d. Includes children’s tax credit, working families’ tax credit, working tax credit unless specifically identified as for those without children in Budget documentation, child tax credit, Child Trust Fund and child benefit.
e. Includes winter fuel payments, free TV licences, basic state pension, minimum income guarantee and pension credit.

Source: Authors’ calculations using table 1 of HM Treasury Budget Report and PBR, various years. Thanks to Rowena Crawford for her help in computing the numbers in this table.

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Table 2.1. Revenue effects in 2010–11 of tax and benefit changes implemented between 1997 and 2010, £ billion

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<td>£8.1</td>
<td>£7.1</td>
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Notes and Source: See previous page.
2.1 Income tax

The main changes to income tax since 1997 have been:

- a reduction, in stages, in the basic rate of income tax from 23p to 20p;\(^2\)
- replacing the 20p lower rate with a 10p starting rate in April 1999, but then abolishing this for non-savings income in April 2008;
- the introduction of a new 50p rate above £150,000 and the withdrawal of the personal allowance from those with high incomes from April 2010;
- the abolition of the married couple’s allowance for those born after 5 April 1935;
- the abolition of mortgage interest tax relief for owner-occupiers (known as MIRAS).

In April 1999, the 20p ‘lower’ rate of tax was replaced with a 10p ‘starting’ rate of tax on a narrower band of income. It is not clear why a lower tax rate on a small band of taxable income was preferable to a higher income tax allowance, and thus the abolition of the 10p rate, which came into effect in April 2008, represented a welcome simplification of the income tax system. However, the simplifying effect was limited by the decision to keep the 10p rate in place for savings income. The abolition of the 10p rate, combined with a 2p cut in the basic rate from 22p to 20p, proved controversial, as many low-income families lost out as a result (although many others were protected by reforms announced at the same time). In May 2008, the government announced a £600 increase in the personal allowance to compensate most, but not all, of those who had lost out.

The other change to the structure of income tax has come at the other end of the income distribution. In 2010–11, there is a new 50p additional rate of income tax applying on income over £150,000, and the income tax personal allowance is being gradually withdrawn from those with incomes over £100,000, which effectively creates a small band of income where the marginal income tax rate is 60%. While it may be desirable to have higher marginal rates slightly below the top of the income distribution than at the very top, it seems unlikely that the optimal tax structure would involve the marginal income tax rate increasing from 40% to 60% and then falling to 40% again as it does in the current system. The 50p rate is not expected to be a large revenue-raiser for the government – Budget 2009 estimated that it would raise £2.4 billion in a full year – and it is likely to provoke a large behavioural response among those affected. Treasury figures suggest that the 50p rate would raise £7.8 billion in a full year if there were no behavioural response.\(^3\) Indeed, although there is considerable uncertainty over the size and nature of the behavioural response, it is possible that the reform will end up costing the government money if very high-income individuals respond to the increase in their marginal tax rate to the same extent that they did when it was cut during the 1980s and expenditure falls by as much as income in response to tax changes.\(^4\)

Two significant tax reliefs have been abolished over the last 13 years – namely, mortgage interest tax relief (MIRAS) and the married couple’s allowance. MIRAS provided an effective subsidy to investment in a primary residence, and its abolition has helped create a more uniform treatment of different asset types. The abolition of mortgage interest deductibility has been an achievement that few other countries have been able to emulate.

\(^2\) The basic rate was 24p in 1996–97, but the Conservative government then pre-announced a cut to 23p from April 1997.


Something that is not counted as a ‘reform’ in Table 2.1 is the fact that income tax thresholds have not kept pace with income growth. The result, shown in Figure 2.1, has been that the number of higher-rate taxpayers (those who pay some tax at the 40% higher rate, indicated by the difference between the two lines in figure 2.1) has increased from 2.1 million in 1997–98 to 3.1 million in 2009–10. This phenomenon is known as ‘fiscal drag’.

Figure 2.1. Number of taxpayers, 1973–74 to 2009–10


To demonstrate further the effect of ‘fiscal drag’ on income tax receipts, Figure 2.2 shows the income tax schedule for a single adult aged under 65 without a mortgage in 2010–11 and compares this with the 1997–98 schedule uprated first with prices and second in line with per-capita national income. The black line is the change in annual income tax payment since 1997 and is plotted on the right-hand axis. We can see that tax thresholds, particularly the threshold at which the higher 40% rate starts to be paid, have not kept pace with income growth in the whole economy. This means that, while a higher-rate taxpayer would have to pay around £1,100 more in income tax under a price-indexed 1997–98 income tax system, they would have to pay around £200 less under an income tax system where the thresholds had been increased in line with per-capita national income.
2.2 National Insurance

The main changes to National Insurance contributions (NICs) since 1997 have been:

- the abolition of the 'entry rate' for both employees and employers;
- increases in the main National Insurance (NI) rate from 10% to 11% for employees and from 10% to 12.8% for employers;
- the extension of employee NICs above the upper earnings limit (UEL).

The NI system has changed considerably since 1997. In 1997, no NICs were payable for those earning less than £62 per week, but then those earning £62 per week or more had to pay 2% (and their employer 3%) on all their earnings, creating a jump in contributions at this point. The...
employers’ NI schedule had a number of additional jumps as the rate was increased at different points and the higher rate applied to earnings below that level as well. It is unsurprising that this led to bunching in earnings just below the various thresholds. The ‘entry rate’ was abolished in 1999, and since then the NI threshold has operated in a similar way to the income tax personal allowance, essentially being deducted from earnings to get taxable earnings.

Another change to the structure of NI was the extension of employees’ NICs above the UEL in 2003. These changes mean that, even more so than in 1997, NI is now effectively a second income tax on earned income. Although there is little economic rationale for the existence of two different systems, and it makes the tax system more opaque, complex and administratively expensive, the substantial problems caused by the lack of integration have been reduced by the increased alignment of the two systems.

Figure 2.3 shows the combined income tax and (employees’ and employers’) NI schedule (note, in cash terms rather than the marginal rate schedule as in Figure 2.2) in 2010 and 1997, with thresholds increased first in line with the RPI and second in line with per-capita national income. We can see that increasing thresholds in line with national income is not necessarily more generous to taxpayers than price-indexation – since the rate of NI falls at the UEL, the higher UEL under the 1997 system with thresholds increased in line with national income means that some individuals have to pay more NI under this system than under the 1997 system with thresholds increased in line with the RPI.

Figure 2.3. Combined income tax and NI schedule, 1997–98 and 2010–11
Thresholds increased in line with prices
Thresholds increased in line with per-capita national income

Note: Assumes single adult aged under 65, all income earned, only one job, no mortgage, contracted in to Second State Pension.
Source: Authors’ calculations.

2.3 Indirect taxes

- There have been relatively few changes to VAT since 1997 – the 8% rate on domestic fuel and power was reduced to 5% shortly after Labour came to power (fulfilling a manifesto promise), and this rate has since been extended to a few other goods that were previously subject to the 17.5% rate.

- There was a duty escalator (i.e. a pre-announced above-inflation increase every year) in place on tobacco and road fuels during Labour’s first term of office, which stopped in 2000. Recently, however, fuel and tobacco duty escalators have been reintroduced, and an alcohol duty escalator has been introduced for the first time.

- Aggregates levy and the climate change levy have been introduced, and the rates of air passenger duty and landfill tax have been increased, although these all remain fairly small revenue-raisers.

Figure 2.4 shows how total duties on various goods have changed since 1997.
When Labour came to power, there were so-called escalators in place for road fuel and tobacco duties that had been introduced by the previous Conservative government. These were then made steeper (i.e. the increase in duties each year was made bigger) in Labour’s first Budget in 1997, which led to tobacco duty increasing by 27% and fuel duties increasing by 22% in real terms between 1997 and 2000. Since 2000, however, tobacco duty has barely kept pace with inflation. The fuel duty escalator policy remained in place until the Pre-Budget Report of 1999, when the escalator was abandoned (the policy was not abandoned as a result of the fuel price protests, as is often misremembered; these took place in Autumn 2000, almost a year later). Road fuel duties then fell by a fifth in real terms between 2000 and 2008.5 In 2009, the government increased road fuel duties in real terms, and announced a fuel duty escalator of 1p/litre per year in real terms until 2013. This was extended to 2014 in the 2010 Budget, although the increase that was due to come in on 1 April will instead be phased in, with increases also taking place in October and January 2011. The 2010 Budget also announced an immediate 1% real increase in tobacco duties, and a tobacco duty escalator of 2% a year in real terms until 2014.

Duties on wine and beer were left unchanged in real terms from 1997 to 2008, while the duty on spirits was left unchanged in nominal terms (i.e. cut in real terms) between 1998 and 2008. This helped to narrow the gap between spirits and other forms of alcoholic drink in terms of how highly they are taxed per unit of alcohol, which might seem to be a reasonable starting point for the taxation of alcohol. In Budget 2008, the government announced an immediate 6% increase in all alcohol duties, and an alcohol duty escalator of 2% a year in real terms until 2012. This was extended to 2014 in Budget 2010.

Since 1997, the government has introduced two new environmental taxes (the climate change levy and the aggregates levy) and significantly increased the rates of air passenger duty and landfill tax. However, none of these is a large revenue-raiser – the largest, air passenger duty, is expected to raise only £2.3 billion in 2010–11 out of total government revenues of £530.3 billion. Therefore, it remains the case that environmental taxation in the UK is dominated by taxes on motoring – fuel

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duties are expected to raise £27.5 billion a year in 2010–11 (plus VAT on top of the duty) and vehicle excise duty a further £6 billion.

2.4 Capital taxes

- There have been two major reforms to capital gains tax since 1997. In 1998, indexation allowances were abolished and a system of ‘taper relief’ was introduced. In 2008, taper relief was itself abolished and replaced with a flat 18% rate.
- Graduated rates of stamp duty on property (stamp duty land tax) have been introduced.
- It is now possible for spouses and civil partners to transfer unused portions of the inheritance tax nil-rate band to the surviving spouse after the first death.

Capital gains tax (CGT) has undergone two major reforms since 1997. In 1998, the government abolished indexation allowances (which ensured that only real capital gains were taxed, not those that had accrued purely as a result of inflation) for future gains and introduced a system of ‘taper relief’ for longer-held assets. This reduced the amount payable on longer-held assets by up to 75% depending on the type of asset, and meant that higher-rate income tax payers had to pay only a 10% rate on gains on business assets that had been held for at least two years. This system created an incentive for investors to invest in business rather than non-business assets and to hold assets for longer than they otherwise would have done, and introduced a considerable amount of complexity to the system. Many commentators also thought it was unfair that private equity managers could obtain a much lower tax rate of 10% on what was essentially labour income through ‘carried interest’ arrangements, although the same point applied to small business owners, who could choose to forgo some or all of their salary to increase the value of their business and then sell it on so that income would be taxed as capital gains. Therefore, in the 2007 Pre-Budget Report, the government announced a flat 18% CGT rate to apply from 2008. However, the fact that the CGT rate on long-held business assets had increased from 10% to 18% provoked an angry response from business organisations, and the government introduced an entrepreneurs’ relief, which allows the first £1 million of gains from certain business assets (increased to £2 million in Budget 2010) to be taxed at a lower 10% rate. By reintroducing a distinction between different types of assets, this undid some of the simplification of the initial reform proposal. Generally, the instability of the CGT system over the last 10 years, with the introduction of taper relief followed by its abolition, and then the government’s original reform proposal in the 2007 PBR being hastily rewritten, has been undesirable, causing uncertainty for those who have accrued capital gains and who are unsure about what tax regime will exist when they come to realise them.

Looking over the period as a whole, we have moved from a system where income and capital gains tax rates were aligned and there was relief for inflation to one with a lower flat capital gains tax rate with no allowance for inflation. While high tax rates do discourage saving, investment and entrepreneurship, it is not clear that a low CGT rate is the most efficient way of encouraging these activities, and it provides a distortion in favour of occupations in which remuneration can be taken in the form of capital gains. The absence of any allowance for inflation also seems to be a step backwards – it is not clear why gains that have solely come about as a result of increasing nominal

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6 Environmental taxation will be covered in more detail in another Election Briefing Note in this series: P. Johnson, A. Leicester and P. Levell, Environmental Policy Since 1997, IFS 2010 Election Briefing Note.

7 Initially, individuals had to hold on to business assets for 10 years to obtain the lowest 10% CGT rate; this was reduced to four years in Budget 2000 and to two years in Budget 2002.

prices should attract a tax liability. Therefore, it is far from clear that Labour’s reforms have improved the efficiency of the system for taxing capital gains.

2.5 Corporation tax

- Reforms to corporation tax since 1997 have generally been in line with those enacted by the previous Conservative government, and with international trends, in reducing the statutory rate of corporation tax but broadening the base by reducing the generosity of capital allowances.

- However, reforms affecting small companies since 2008 have gone in the opposite direction, with the small companies’ corporation tax rate increasing from 19% to 21% and with the introduction of a £100,000 tax allowance for investment in plant and machinery.

- A lower rate of corporation tax for companies with less than £10,000 of taxable profit was introduced at 10% in April 2000, and cut to 0% in April 2002. This provided a strong incentive for the self-employed to incorporate to take advantage of this lower tax rate. Having not anticipated this, the government reversed the reform in December 2005. The net effect has been to cause these individuals inconvenience and expense in setting up incorporated businesses, and provides a clear lesson in how not to make tax policy.

- The abolition of the dividend tax credit for tax-exempt shareholders increased the rate of tax paid by pension funds, charities and certain individuals on the returns earned by their investments. While these returns are still exempt from income tax, these exempt taxpayers will not now get the corporation tax on profits that are distributed to them refunded.

Between 1997 and 2002, the main corporation tax rate fell from 33% to 30% and the small companies’ rate fell from 24% to 19%. Budget 2007 reduced the main rate further to 28%, but at the same time reduced capital allowances (for example, the allowance for most plant and machinery was reduced from 25% to 20%). This reduction of both the statutory rate and capital allowances is very much in line with the policies of the previous Conservative government, and with international trends. However, at the same time as reducing the statutory corporate tax rate and capital allowances for large companies, the government departed from this trend by announcing that the small companies’ rate would increase to 22% (now, by 2011) but the first £50,000 of investment in plant and machinery would be tax deductible. This figure was increased to £100,000 in Budget 2010. The rationale for the small companies’ rate (which applies to companies with low profits, rather than to those that are ‘small’ in the way we usually understand) has always been unclear, and so any reform that moves to equalise the two rates is to be welcomed.

In April 2000, a 10% lower rate was introduced for companies with less than £10,000 of taxable profits, and this lower rate was cut to zero in April 2002. This last tax cut came as a surprise, with costs potentially running into billions of pounds if self-employed individuals registered as companies to reduce their tax liabilities.9 Having apparently failed to anticipate this effect, the government swiftly reversed the reform. In April 2004, the zero rate was abolished for distributed profits, removing much of the tax advantage but at a cost of greater complexity; and so in December 2005, the zero rate was abolished for retained profits as well. This takes us back to precisely where we were before April 2000, with the standard small companies’ rate applying to all firms with profits up to £300,000, regardless of whether the profits are paid out as dividends or retained by

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the firm. In the meantime, there has been unnecessary upheaval in the tax system, and thousands of
individuals have incurred effort and expense to set up legally incorporated businesses that they
would not otherwise have set up. This episode provides a clear lesson in how not to make tax
policy.

A major change to the taxation of dividends paid out by companies to shareholders was the
abolition of the dividend tax credit (a deduction from income tax to reflect the corporation tax
already paid on the profits distributed) for tax-exempt shareholders, notably pension funds. This
effectively meant that, although pension funds, charities and other exempt taxpayers are still
exempt from income tax, they now have to pay corporation tax on profits that are distributed to
them through dividends. Therefore, if the aim of policy on the taxation of pensions is to ensure that
returns are exempt from income tax, this policy change removed a subsidy on pension saving (by
removing a credit given to already-exempt taxpayers). However, if the aim is a more general tax
exemption, this policy change increased the tax on returns earned by pension funds on their
investments (by no longer compensating them for corporation tax that had already been paid).
Opponents of this measure often claim that it reduced the income of pension funds by £5 billion per
year – in fact, only £3.5 billion of the £5.4 billion raised by the policy came from pension funds, with
the remainder from other exempt taxpayers such as charities and some individuals.10 Also, the
concurrent cut in the main corporate tax rate from 33% to 31%, and a further cut to 30% in 1999,
would have boosted the incomes of pension funds by up to £1 billion, reducing the net cost to
pension funds to £2.5 billion or less.11

2.6 Tax credits and benefits

The most dramatic structural change to the benefits system since 1997 has been the use of tax
credits to deliver and expand support that was previously delivered through the benefit system.
Other changes have included:

- the introduction of a direct subsidy for childcare;
- the introduction of pension credit to replace Income Support for pensioners;
- the introduction of winter fuel payments for those aged 60 and over;
- the introduction, and then scaling-back, of local housing allowance;
- the replacement of incapacity benefit and Income Support on the grounds of disability with
  employment and support allowance.

Tax credits have increased the generosity of both in-work and out-of-work benefits for families
with children, and have introduced in-work benefits for those without children. The replacement of
family credit by the working families’ tax credit (WFTC) in 1999 strengthened the incentive to work
for lone parents and the incentive for couples with children to have one worker rather than none,
and was generally considered to have increased the employment rate among these groups.12 In
April 2003, the child and working tax credits were introduced to replace WFTC, support for

10 See A. Steventon, Is £5bn Being Taken Every Year from Pension Funds?, Briefing Note no. 22, Pensions Policy Institute,
London, 2005 (http://www.pensionspolicyinstitute.org.uk/uploadeddocuments/PPI_Briefing_Note_22.pdf) and box 1 of C.
Emmerson, G. Tetlow and M. Wakefield, Pension and Saving Policy, IFS 2005 Election Briefing Note no. 12, Institute for

11 More information on corporation tax will be available in a separate Election Briefing Note examining the corporate tax
environment, productivity and innovation. This will be released soon after manifestos have been published.

12 For a discussion of various estimates of the effect of WFTC on employment, see M. Brewer and J. Browne, The Effect of
the Working Families’ Tax Credit on Labour Market Participation, Briefing Note no. 69, Institute for Fiscal Studies,
children given to those out of work through Income Support (IS), a non-refundable tax break called the children’s tax credit and child additions to other benefits. The new system of administering tax credits has led to some families receiving more than their entitlement, and others receiving less, mostly because of administrative errors or because HMRC was not informed quickly enough about changes in family circumstances. While the scale of these problems has decreased since the first year of the operation of the new tax credits, in 2007–08 around £1.7 billion was overpaid and around £220 million was underpaid to tax credit claimants.\textsuperscript{13}

The introduction of WFTC included a direct childcare subsidy for parents for the first time. (Previously, some expenditure on childcare had been deductible from income for the family credit means test.) However, relatively few families benefit from the childcare element of the working tax credit (478,000 in December 2009).\textsuperscript{14} This is because the conditions attached to it are fairly stringent: both parents in a couple have to be working at least 16 hours per week, it is only available for registered childcare usage and it is means-tested.

The system of tax credits is much more generous to low-income families with children than the 1997 benefits system. Similarly, pension credit is much more generous to pensioners than the 1997 Income Support system. The pension credit guarantee operates in a similar way to the old IS system in that it tops the incomes of those aged 60 and over up to a minimum level (meaning that there is a 100% taper rate), but there is now also a savings credit component which, when taken together, leads to those aged 65 and over having a lower withdrawal rate of 40% for individuals and couples with small amounts of private income on top of a full basic state pension (BSP). The effect of this has been to reward these families, who previously found that their other income reduced their means-tested benefit entitlement on a pound-for-pound basis.\textsuperscript{15}

Another change affecting pensioners over the last 13 years has been the introduction of winter fuel payments (WFP) for those aged 60 or over, which are neither taxable nor means-tested.\textsuperscript{16} The rationale for these payments has never been made clear – it is not obvious why they should be universal payments rather than a lump sum paid as part of the basic state pension, which would be worth less to richer pensioners as the BSP is taxable. Furthermore, policy in this area seems to have been made on an ad-hoc basis, with numerous ‘one-off’ increases in WFP having been announced in Budgets and PBRs. Indeed, the rates of WFP have been changed seven times over the 13 winters Labour has been in charge.\textsuperscript{17}

In April 2008, the housing benefit (HB) system was replaced by the local housing allowance (LHA) for new claimants and those moving house in the private rented sector. Under the old system, the maximum amount available to claimants was the amount of rent they had to pay (up to a maximum local reference rent). This provided no incentive for claimants to find cheaper accommodation, as HB would cover however much rent they had to pay. This was the rationale for introducing the LHA system, whereby claimants were given the amount of money deemed necessary to rent


\textsuperscript{16} Despite their name, winter fuel payments have nothing to do with winter fuel – they are cash payments that can be spent on anything.

\textsuperscript{17} See J. Browne, ‘Direct taxes and benefits’, IFS Post-Budget Briefing 2008 presentation, 2008 (http://www.ifs.org.uk/budgets/budget2008/direct_taxes.ppt). The ‘one-off’ increase for 2008 mentioned in the table on slide 10 was subsequently extended to 2009, and then 2010, meaning that there have been seven rather than eight changes to the rates of WFP.
accommodation suitable for their family in their local area. In the pilot schemes for this policy, claimants could keep any surplus if their LHA exceeded their rent, but when the policy was rolled out nationally, gains were limited to £15 per week. This reduced the potential cost of the policy, but limited the incentive for claimants to seek cheaper accommodation. Despite this restriction, the cost of the policy greatly exceeded previous estimates, mainly because the amounts given for LHA were greater than the previous local reference rents. Therefore, in the 2008 Pre-Budget Report, less than a year after the scheme was introduced, the government announced that it would cap rents at the five-bedroom rate, and look at ways of reducing the cost of the scheme. In Budget 2009, it was announced that it would no longer be possible for claimants to receive more in LHA than they had to pay in rent from April 2010, effectively reversing the key policy change that had been brought about. Perhaps in belated recognition of this, the government announced in PBR 2009 that it would delay this change until April 2011, and undergo a consultation in the meantime. The introduction of LHA also involved payments being made to claimants rather than direct to landlords, as was previously the case. Qualitative evaluation of the LHA pilot scheme indicated that this had led to landlords becoming less willing to let properties to tenants who were claiming LHA.\(^\text{18}\) Despite this, there is no indication that the government will reverse this part of the scheme.

Another change to the benefits system has been the replacement of incapacity benefit (IB) and Income Support on the grounds of disability with employment and support allowance (ESA) for new claimants. The main change was to the health conditions that claimants have to satisfy, which are intended to be stricter and thus lead to fewer individuals being able to move onto the benefit – indeed, between September and November 2009, around two-thirds of claimants were judged to be fit for work according to the work capability assessment.\(^\text{19}\) This compares with around half of claimants under the previous personal capability assessment.\(^\text{20}\) The change also involved the introduction of the Pathways-to-Work programme, which provides claimants with mandatory work-focused interviews, additional support and a time-limited financial incentive to encourage them to move back into paid work. IFS research has suggested that the measured financial benefits of this scheme to the exchequer exceeded the measured financial costs for new claimants in the initial pilot areas.\(^\text{21}\)

### 2.7 Summary

Labour’s reforms have in many ways been a continuation of reforms under the previous Conservative government, and in line with international trends – for example,

- reducing the basic rate of income tax while not increasing tax thresholds in line with income growth;
- moving towards a completely individual-based income tax system by abolishing the married couple’s allowance (except for those born before 6 April 1935);
- abolishing mortgage interest tax relief for owner-occupiers (although the UK is one of the few countries to have accomplished this in its entirety);
- moving to align the income tax and NI systems;

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\(^{19}\) See [http://research.dwp.gov.uk/asd/workingage/esa_wca/esa_wca_19012010.pdf](http://research.dwp.gov.uk/asd/workingage/esa_wca/esa_wca_19012010.pdf).


• introducing some relatively small environmental taxes;
• reducing the main rate of corporation tax, while broadening the tax base;
• increasing the level of in-work support given to families with children.

However, certain aspects of Labour’s reforms have run contrary to international trends, or those before 1997. For example,

• means-tested benefits and tax credits for low-income families with children and pensioners have been increased much faster than they were before 1997;
• the new 50p (and 60p) income tax rates go against the trend – at least before the financial crisis – for there to be fewer and lower income tax rates;
• capital gains tax has become a flat-rate tax (with no allowance for inflation, as it was before 1982); 22
• the period from 2000 to 2008 saw the first sustained real-terms cut in the duty rate for road fuels since 1979.

There have also been several instances where Labour has introduced tax changes without proper consultation that have turned out to be undesirable and were subsequently reversed – namely,

• taper relief in capital gains tax;
• the 10p income tax rate;
• the 0% rate of corporation tax.

3. The distributional effect of tax and benefit reforms

This section analyses how changes in taxes and benefits since 1997 have affected the distribution of income between different households. We do this by grouping households (separately) along two dimensions: their position in the income distribution and their composition (age, partnership status, work status and whether they contain children).

The starting point of this analysis is to simulate what the tax and benefit systems that existed at the times of the 1997, 2001 and 2005 general elections would have looked like in April 2010 if there had been no policy reforms since, and to compare that situation with the actual system in force in April 2010. We initially assume that this ‘no policy change’ baseline is equivalent to uprating each benefit and tax in line with the assumptions underlying the government’s public finance forecasts. This nearly always means uprating thresholds and cash amounts in line with various measures of inflation. The main attraction of this approach is that it ensures consistency with the government’s own costings.

However, because the economy grows over time, uprating in line with inflation is not sustainable indefinitely as it eventually leads to taxes increasing to 60% of national income, and so in Section 3.4 we instead assume that ‘no policy change’ means uprating in line with growth in national income per capita as an alternative. In Section 3.2, we analyse how our results change if we include the impact of changes in council tax. Section 3.3 looks at how our results are affected by the fact that tax and benefit changes have had a significant effect on net incomes and have changed the ordering of households in the income distribution.

22 There is, however, entrepreneurs’ relief, which gives a lower rate of CGT for the first £2 million of gains on certain business assets.
We then use the IFS tax and benefit microsimulation model, TAXBEN, to calculate tax liabilities and benefit entitlements of households observed in the 2006–07 Family Resources Survey and 2007 Expenditure and Food Survey, using information about household incomes, demographics and consumption patterns. However, there are a number of measures that we cannot allocate to specific households using TAXBEN, which are predominantly taxes levied on businesses and on capital gains. These are hard to allocate to particular households, because patterns of stock ownership through institutions such as unit trusts and pension funds make it very difficult to know how share ownership and dividend incomes are distributed across the population, and therefore to whom we should allocate such taxes.\textsuperscript{23} Simply excluding any reforms to business taxation would create a misleading impression, however: ultimately, all taxes are paid by households. As a crude solution, therefore, we assume that all tax and benefit changes not modelled in TAXBEN have an equal proportionate impact on all households (~4.0% since 1997). The effect of this is to alter the height of all the bars in Figure 3.1 and other similar figures by this amount. If the changes not modelled in TAXBEN have, instead, impacted more on richer households (who own more shares, for instance), then the real picture of reform will more redistributive than shown here, and vice versa.

More detail of our methodology can be found in the Appendix.

3.1 The distributional impact of Labour’s reforms relative to the public finance ‘no change’ scenario

Figure 3.1 shows the estimated effect in 2010–11 of all tax and benefit reforms introduced by central government since 1997 across the income distribution. It excludes council tax, which is set by local authorities and discussed in Section 3.2. The government’s reforms have represented a net takeaway of a total of £7.1 billion corresponding to an average net loss of £271.58 per household per year or 0.9% of households’ disposable income (the black line in Figure 3.1).

Reforms have been broadly progressive, with the poorest 10% of households gaining, on average, an amount equal to 12.8% of their income under the April 2010 system and the richest 10% of households losing an amount equal to about 8.7% of their net incomes.

Figure 3.2 breaks down the overall changes between the impact of measures implemented in Labour’s first and second terms. As we showed earlier, Labour’s first-term reforms entail a net giveaway in 2010–11 of £7.5 billion (or a net gain to households of £292.30 per household per year, on average), the second-term reforms entail a net takeaway of £6.4 billion (or a net loss to households of £247.31 per household per year) and the third-term reforms amount to a net takeaway of £8.1 billion (£316.57 per household per year). The losses in the second and third terms are concentrated amongst households in the top half of the income distribution, with gains on average in the bottom half of the population. It is clear that the government has given away less and taken away more in its third term than in the previous two terms, with most of the takeaway implemented in the wake of the 2008–2009 recession.

\textsuperscript{23} These taxes may also be borne by consumers (in the form of higher prices) or workers (in the form of lower wages) as well as by the owners of business equity.
Figure 3.1. Gains and losses across the income distribution from tax and benefit reforms implemented since 1997

Notes: Income decile groups are derived by dividing all households into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth. Sources: Family Resources Survey, 2006–07; Expenditure and Food Survey, 2007; various Budget and Pre-Budget reports; authors’ calculations.

Figure 3.2. Gains and losses across the income distribution from tax and benefit reforms in the 1997, 2001 and 2005 parliaments

Notes: As Figure 3.1. Source: As Figure 3.1.
Most of the losses for the top 10th of the population resulting from reforms in the third term are the result of changes to income tax affecting only those households where someone has income of over £100,000 (only about 2% of all households). Figure 3.3 puts those households containing someone with an income of over £100,000 a year in a separate eleventh group and keeps the remaining households in their original decile group (with the 10th group now representing the eight out of ten households in the top 10% of the income distribution that do not contain someone with an income of over £100,000 a year). The graph shows that the significant losses for the top 10% of the population (representing 8.8% of net income) are concentrated amongst those households where someone has an income over £100,000. Tax and benefit reforms under Labour have cost these households the equivalent of 14.8% of their net income, as opposed to 4.6% for the rest of the top 10%. Nearly all of this difference is caused by reforms during the third term of the Labour government, where the losses are 10.2% and 0.6% respectively. Indeed, it is nearly all driven by changes in income tax that came into effect in April 2010.

Figure 3.3. Gains and losses across the income distribution from tax and benefit reforms since 1997 (with £100,000+ category)

Table 3.1 shows how changes since 1997 affect different household types on average. We can see a pattern of losses on average for working-age adults without children, and gains on average for lone parents, non-working households with children and pensioners. The first two columns include those households where someone has an income of over £100,000, whilst in the second two columns these are shown as their own group. Showing the losses for households with someone with an income of over £100,000 as a separate group can make a significant impact. For instance, if we consider all two-parent families with one person in paid work, there is an average loss of 1.3% due to reforms under Labour. However, this turns to an average gain of 5.8% of net income if we consider only those households that do not contain someone earning over £100,000 per year. There are similar, but generally much smaller, differences depending on whether one counts the £100,000+ households separately for nearly all of the household types considered.

24 These changes are the new 50% tax rate on income above £150,000 a year, and the phasing-out of the personal allowance for those with incomes above £100,000 a year.
Table 3.1. Average gains and losses for different household types from tax and benefit reforms since 1997

<table>
<thead>
<tr>
<th>Household type</th>
<th>Groups include £100k+ individuals</th>
<th>Separate group for £100k+ individuals</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td>£ per year</td>
</tr>
<tr>
<td>Single, not working</td>
<td>-1.8%</td>
<td>-176.31</td>
</tr>
<tr>
<td>Single, working</td>
<td>-4.6%</td>
<td>-1071.07</td>
</tr>
<tr>
<td>Lone parent, not working</td>
<td>16.1%</td>
<td>2569.71</td>
</tr>
<tr>
<td>Lone parent, working</td>
<td>12.4%</td>
<td>2719.47</td>
</tr>
<tr>
<td>0-earner couple, no children</td>
<td>-1.3%</td>
<td>-258.38</td>
</tr>
<tr>
<td>0-earner couple, children</td>
<td>16.0%</td>
<td>3257.81</td>
</tr>
<tr>
<td>1-earner couple, no children</td>
<td>-5.3%</td>
<td>-1665.01</td>
</tr>
<tr>
<td>1-earner couple, children</td>
<td>-1.3%</td>
<td>-484.94</td>
</tr>
<tr>
<td>2-earner couple, no children</td>
<td>-4.7%</td>
<td>-2056.48</td>
</tr>
<tr>
<td>2-earner couple, children</td>
<td>-3.5%</td>
<td>-1585.27</td>
</tr>
<tr>
<td>Single pensioner</td>
<td>9.9%</td>
<td>1350.15</td>
</tr>
<tr>
<td>Couple pensioner</td>
<td>3.2%</td>
<td>755.06</td>
</tr>
<tr>
<td>Multi-family household, no children</td>
<td>-2.6%</td>
<td>-1030.26</td>
</tr>
<tr>
<td>Multi-family household, children</td>
<td>1.6%</td>
<td>689.02</td>
</tr>
<tr>
<td>Household contains individual with £100,000+ income</td>
<td></td>
<td>-14.7%</td>
</tr>
</tbody>
</table>

Notes: As Figure 3.1.
Sources: As Figure 3.1.

Table 3.2 shows how changes since 1997 have affected households across the different regions and countries of the UK, on average. We can see a pattern of losses on average for southern regions of England, the North West of England, and Wales, with gains on average for households in the North East of England, Yorkshire and Humberside, the East and West Midlands and Northern Ireland. The differences in average gains and losses across the regions and countries of the UK are much smaller than the differences by household type and by position in the income distribution. This reflects the fact that in regions generally considered ‘poor’ (such as Wales and the North East of England), not everyone has low incomes, and in regions generally considered ‘rich’ (such as the South East of England and, particularly, London), not everyone has high incomes. The first two columns of Table 3.2 include those households where someone has an income of over £100,000, whilst in the second two columns these are shown as their own group. Showing the losses for households with someone with an income of over £100,000 as a separate group can make a significant impact. For instance, if we consider all households in London, there is an average loss of 3.3% due to reforms under Labour. However, this becomes an average loss of 0.2% of net income if we consider only those households that do not contain someone earning over £100,000 per year. There are similar, but generally much smaller, differences depending on whether one counts the £100,000+ households separately for all the parts of the UK considered.
Table 3.2. Average gains and losses for the regions and countries of the UK from tax and benefit reforms since 1997

<table>
<thead>
<tr>
<th>Household type</th>
<th>Groups include £100k+ individuals</th>
<th>Separate group for £100k+ individuals</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>% % £ per year</td>
<td>% £ per year</td>
</tr>
<tr>
<td>North East of England</td>
<td>1.4% 348.54</td>
<td>1.6% 394.40</td>
</tr>
<tr>
<td>North West of England</td>
<td>−0.4% −102.50</td>
<td>−1.8% 455.34</td>
</tr>
<tr>
<td>Yorkshire and Humberside</td>
<td>0.5% 144.74</td>
<td>1.3% 341.36</td>
</tr>
<tr>
<td>East Midlands</td>
<td>0.1% 28.81</td>
<td>1.1% 273.90</td>
</tr>
<tr>
<td>West Midlands</td>
<td>0.8% 222.17</td>
<td>1.5% 403.00</td>
</tr>
<tr>
<td>East of England</td>
<td>−1.5% −476.95</td>
<td>0.1% 40.96</td>
</tr>
<tr>
<td>London</td>
<td>−3.3% −1213.66</td>
<td>−0.2% −49.72</td>
</tr>
<tr>
<td>South East of England</td>
<td>−2.1% −718.62</td>
<td>−0.2% −67.29</td>
</tr>
<tr>
<td>South West of England</td>
<td>−0.8% −228.00</td>
<td>0.7% 190.31</td>
</tr>
<tr>
<td>Wales</td>
<td>−0.6% −177.80</td>
<td>1.7% 426.22</td>
</tr>
<tr>
<td>Scotland</td>
<td>0.0% 4.22</td>
<td>0.7% 190.60</td>
</tr>
<tr>
<td>Northern Ireland</td>
<td>1.4% 378.65</td>
<td>1.7% 462.70</td>
</tr>
<tr>
<td>Contains individual with £100,000+ income</td>
<td>−14.8% −26228.94</td>
<td></td>
</tr>
<tr>
<td>All</td>
<td>−0.9% −271.58</td>
<td>−0.9% −271.58</td>
</tr>
</tbody>
</table>

Notes: As Figure 3.1.
Sources: As Figure 3.1.

We now show how our results are sensitive to a number of choices we have had to make to model the tax and benefit reforms under Labour. We show, separately:

- the impact of including changes in council tax (Section 3.2);
- how our results are affected by the fact that tax and benefit changes have caused people to change rank in the income distribution (Section 3.3);
- how things look if our ‘no policy change’ baseline is a world where the government had uprated benefits, tax credits and tax thresholds by national income per capita (Section 3.4).

### 3.2 Council tax

Council tax (net of council tax benefit) will make up an estimated 4.8% of government revenues in 2010–11, up from 4.4% in 2005–06 and 3.5% in 1997–98. The analysis in Section 3.1 ignored council tax because the rates are not set directly by central government. However, central government grants and demands on local authorities heavily influence local authorities’ decisions, and, since 2004–05, the government has sometimes capped increases it has thought excessive. Given this, and because council tax changes directly affect households’ disposable incomes, there is a case for including council tax changes in the analysis.

We compare actual rises in council tax with a counterfactual ‘no change’ baseline in which all council tax rates rise in line with inflation. Actual rises were substantially above inflation in Labour’s first two parliaments, increasing by an average of 4.0% per year and 5.2% per year in real terms between April 1997 and April 2001 and between April 2001 and April 2005, respectively. In the third term, the average real increase was a much more modest 0.4% per year. We estimate that,
in total, these increases raise £7.6 billion in 2010–11, net of any consequential effect on council tax benefit. This is an average loss to households of £294.92 per year or 1.0% of disposable income.

Figure 3.4. Gains and losses across the income distribution from tax and benefit reforms since 1997, with and without council tax

![Graph showing gains and losses across the income distribution.](image)

Notes: As Figure 3.1.
Source: As Figure 3.1.

Figure 3.5. Gains and losses across the income distribution from tax and benefit reforms since 1997, with and without council tax (with £100,000+ category)

![Graph showing gains and losses across the income distribution with a separate category for £100,000+ income.](image)

Notes: As Figure 3.1.
Source: As Figure 3.1.

Figure 3.4 shows the effect of including council tax across the distribution. Figure 3.5 repeats the analysis but, as in Figure 3.3, those households containing someone with an income of over £100,000 per year are shown separately. All decile groups lose from real increases in council tax rates. Losses increase in cash terms as we move up the income distribution, but in proportional terms they are highest for decile groups 3 to 6. A significant number of low-income households are protected from increases in council tax because their council tax bills are partly or wholly covered.
by council tax benefit (although the size of this effect is exaggerated here because we assume full take-up of council tax benefit).\textsuperscript{25} Adding council tax changes does not change the broad picture: lower income households have been net gainers from reforms, whilst better-off households have been net losers.

### 3.3 Gains and losses relative to households’ 1997 income and decile group ranking

In Sections 3.1 and 3.2, we ranked people according to their income under the April 2010 tax and benefit system, i.e. those in the poorest decile group are the households whose income is in the bottom 10% of all households \textit{post-reform}, etc. When calculating proportional changes, the total gain or loss for that decile group is divided by the total income for that decile group under the 2010 tax and benefit system. We do this because it is easier to think about who is poor under the tax and benefit system currently in operation and to think about changes in income relative to how much income people have now. It essentially shows how much households in a particular decile group now would gain or lose as a proportion of the net income if we were to go back to a 1997 tax and benefit system, suitably uprated.

In this section, we instead rank people based on what their incomes would have been under the (uprated) April 1997 tax and benefit system, and calculate proportional changes using their incomes under this \textit{pre-reform} tax and benefit system. For groups for which reforms have increased incomes, the proportional increase will look bigger if we use their ‘initial’ income, whilst the proportional fall will look smaller for those who have seen losses. Based on 1997 (pre-reform) incomes and decile groups, the poorest 10% of the population have seen a nearly 28% increase in their net incomes as opposed to just 13% using 2010 (post-reform) incomes and decile groups (see Figure 3.6). There are two reasons for this. First, the gains in income due to tax and benefit reforms since 1997 are so large for those with low incomes that they are a much bigger proportion of their pre-reform income (i.e. their income under the 1997 system) than their post-reform income (i.e. their income under the 2010 system). In addition, many people who would be in the bottom decile group if the April 1997 tax and benefit system were still in place gain so much under the April 2010 system that they are no longer in the bottom decile group, but are now in the 2\textsuperscript{nd}, 3\textsuperscript{rd} or 4\textsuperscript{th} decile group (and likewise, some of those originally in deciles 2 to 4, particularly amongst unfavoured groups such as working-age adults without children, are in the bottom decile group under the April 2010 system). This compositional change acts to reduce the gains for those in the bottom decile (and increase the gains for those in the deciles a bit further up) when using April 2010 decile groups as opposed to the April 1997 decile groups. Gains are slightly smaller (or losses slightly bigger) for decile groups 4 to 9 when using pre-reform incomes. In general, reforms look even more progressive when using 1997 (pre-reform) incomes.

\textsuperscript{25} In fact, the Department for Work and Pensions estimates that only around two-thirds of those who are entitled to council tax benefit take it up. For more information, see DWP, \textit{Income-Related Benefits: Estimates of Take-Up in 2007--08}, 2009 (http://research.dwp.gov.uk/asd/income_analysis/jun_2009/0708_Publication.pdf).
3.4 The impact of Labour’s reforms relative to a baseline of national income indexation

The start of section 3 discussed briefly why the choice of ‘no policy change’ baseline is important. It was suggested that rather than using the no-change assumptions underlying the public finance forecasts (generally uprating in line with inflation), we could instead assume that ‘no policy change’ meant uprating all rates, allowances and thresholds in line with national income per capita. This concept of ‘no policy change’ is appealing, because with tax thresholds increasing in line with the tax base, taxes would remain constant as a share of national income as there would be no extra revenue from ‘fiscal drag’, and benefits would retain their value relative to average incomes in the economy.26 Tax thresholds in the UK have never been increased in line with national income, but benefits tended to increase in line with national income until 1979.27

Using this alternative concept of ‘no policy change’ gives a much larger figure for the net takeaway from households between 1997 and 2010: £36.4 billion per year, or £1,411.93 per household per year (4.7% of their net income). Figure 3.7 shows the impact of tax and benefit reforms measured on net income across the income distribution. The result of moving from uprating in line with the public finance forecasts to uprating in line with national income per capita is, effectively, to shift down the bars for each decile group, with this effect being larger for poorer households. This is because benefits represent a very large proportion of income for low-income households and, while the government has been considerably more generous than the price-uprating assumed under the Treasury baseline on average, actual practice has been broadly in line with uprating benefits in line

Notes: As Figure 3.1.
Source: As Figure 3.1.

26 It is important to realise that whilst uprating tax amounts and thresholds in line with prices (as the government generally does) leads to more revenue from some taxes than if they were uprated in line with national income (for instance, income tax and stamp duties), for other taxes it leads to less revenue (for instance, business rates and excise duties). In our analysis, we capture the ‘fiscal drag’ from taxes such as income tax, National Insurance and excise duties, as well as from the benefits and tax credits system. We assume that the net revenue from ‘fiscal drag’ from taxes we do not model is zero; extra revenue from taxes such as stamp duties are assumed to be offset by losses from taxes such as business rates.

with national income on average since 1997. Hence, instead of significant gains, we now see very small average gains towards the bottom of the income distribution, and households lose on average from the 4th decile group onwards (as opposed to from the 7th decile group using our earlier definition of ‘reform’), with average losses further up the income distribution larger than before.

**Figure 3.7. Gains and losses across the income distribution from tax and benefit reforms since 1997**

![Graph showing gains and losses across income distribution](image)

Notes: As Figure 3.1. The adjustment to account for tax changes not modelled directly is equivalent to 4.0% of net income. Sources: As Figure 3.1.

### 4. The effect of tax and benefit reforms since 1997 on work incentives

This section examines the effect of tax and benefit reforms since 1997 on work incentives. As in our distributional analysis, we need to consider the effects of all aspects of the tax and benefit system. For example, the withdrawal of means-tested benefits can be just as important as taxes in the decision whether or not to work for those on low incomes. And, since the attractiveness of working presumably depends on the quantity of goods and services that can be purchased with net earnings, a tax that increases prices (such as VAT) should have the same effect as one that reduces earnings (such as NI). We must therefore take account of indirect as well as direct taxes.\(^{28}\)

We should also distinguish between the incentive to be in work at all (which can be measured by the participation tax rate (PTR), the proportion of total earnings taken in tax and withdrawn benefits) and the incentive for those already in work to increase their earnings slightly, whether by working more hours, seeking promotion or getting a better-paid job (which can be measured by the marginal effective tax rate (METR), the proportion of a small increase in earnings taken in tax and withdrawn benefits). For both of these, higher values indicate weaker incentives – high PTRs...

\(^{28}\) In what follows, we incorporate indirect taxes by estimating, for each individual, the average tax rate paid on their household’s spending. We can therefore allow for how large the ‘wedge’ between income and the value of consumption is for that person’s household; but this will not quite be an accurate measure of how indirect taxes affect work incentives unless the average tax rate on what additional income is spent on is the same as that on existing purchases.
among non-workers are often referred to as the unemployment trap, while high METRs among low-income families are known as the poverty trap.29

We calculate the effect of Labour’s tax and benefit reforms on the incentive to be in paid work at all in a similar way to that in which we calculated the effect of tax and benefit reforms on household incomes in Section 3. That is to say, we simulate what the tax and benefit system would look like today if there had been no tax and benefit reforms since 1997, 2001 or 2005, and calculate PTRs for each individual under these systems and the actual 2010 tax and benefit system.

However, unlike in Section 3, we make no adjustment to our results to account for those tax and benefit reforms that cannot be easily attributed to particular households. These tend to be reforms that affect taxes that are formally incident on businesses and capital, and they will only affect our measures of financial work incentives if they affect wages, prices or the return to saving.

As in Section 3, we examine reforms both relative to the ‘no change’ assumptions in the public finances and relative to a baseline in which all cash rates and thresholds are increased in line with per-capita national income.

4.1 The effect of Labour’s reforms on average

In this section, we show how Labour’s tax and benefit reforms have affected the incentive to work at all and the incentive to progress in work across the whole population.

The incentive to work at all

In Figure 4.1, we show the distribution of PTRs created by the current 2010 tax and benefit system, and the distributions that would be created by suitably uprated 1997, 2001 and 2005 tax and benefit systems, using the Treasury’s ‘no policy change’ definition.

Figure 4.1. Participation tax rates created by 1997, 2001, 2005 and 2010 tax and benefit systems uprated in line with Treasury ‘no change’ scenario

Notes: Excludes most ‘business taxes’ (notably corporation tax and business rates but not employer NI), and capital taxes (notably inheritance tax, stamp duties and capital gains tax). In-work incomes for non-workers calculated as described in Adam and Browne (forthcoming). Only includes those below state pension age.

Source: Authors’ calculations using TAXBEN run on uprated data from the 2007 Expenditure and Food Survey.

29 The analysis that follows updates that in S. Adam, M. Brewer and A. Shephard, ‘Financial work incentives in Britain: comparisons over time and between family types’, Working Paper no. WP06/20, 2006 (http://www.ifs.org.uk/wps/wp0620.pdf). However, we incorporate employers’ NICs and indirect taxes in our analysis. For more detail on methodology and results, see S. Adam and J. Browne, ‘Redistribution, work incentives and thirty years of UK tax and benefit reform in the UK’, Institute for Fiscal Studies, Working Paper, forthcoming.
We can see that Labour’s reforms have, on average, slightly weakened the incentive to work at all. (The mean PTR has increased from 52.2% to 52.4% as a result of Labour’s reforms.) However, this disguises some variation across the distribution of PTRs, and between Labour’s three terms of office. In Labour’s first term, tax and benefit reforms tended to increase the number of individuals with strong incentives to work (PTRs of less than 40%). Since then, however, tax and benefit reforms have tended to increase PTRs for those who had the strongest incentives to work under the 2001 system – there has been a significant increase in the number of individuals with PTRs between 50% and 60%, and a decrease in the number of individuals with PTRs of less than 50%. However, those who had the weakest incentives to work under the 1997 system have seen their incentive to work strengthened by Labour’s reforms. There are fewer individuals with PTRs of 70% or more. As we can see from Figure 4.2, these conclusions do not depend on whether one uses the ‘no change’ scenario in the public finances or uprating in line with national income as the baseline.

**Figure 4.2. Participation tax rates created by 1997, 2001, 2005 and 2010 tax and benefit systems uprated in line with per-capita national income**

Notes: As for Figure 4.1.
Source: As for Figure 4.1.

**The incentive to progress in work**

In Figure 4.3, we show the distribution of METRs for workers under the current 2010 tax and benefit system, and the distributions that would be created by the 1997, 2001 and 2005 systems, uprated in line with the assumptions in the public finances.
We can see that Labour’s tax and benefit reforms have tended to weaken the incentive for workers to increase their earnings slightly – reforms have significantly increased the number of individuals with METRs of 50% or more. However, Labour’s reforms have reduced the number of workers with extremely high METRs (above 80%). This has come about because of a reduction in the withdrawal rate for in-work benefits. The corollary of this is that more individuals are eligible for means-tested benefits when in work, meaning that many more workers have high METRs, in excess of 70%. Also, since 2005 there has been an increase in the number of workers with METRs below 50% and a decrease in the number with METRs between 50% and 60%; this is a result of the reduction in the basic rate of income tax from 22% to 20% in April 2008.

We see broadly the same picture when we consider reforms relative to the baseline where previous years’ systems are increased in line with per-capita national income (see Figure 4.4).
4.2 How have reforms affected work incentives for different groups?

In this section, we compare how Labour’s tax and benefit reforms have affected the incentive to work at all and the incentive to progress for different groups. We divide people into groups based on whether they have dependent children, whether they are a member of a couple and, if so, whether their partner works.

The incentive to work at all

Table 4.1 shows the mean PTR for each group in 2010, and the simulated mean PTR under suitably uprated 1997, 2001 and 2005 tax and benefit systems. We can see that PTRs for those without children have been broadly unaffected by Labour’s reforms. The main changes are those that have affected people with children. Lone parents and those in couples whose partner does not work have seen their incentive to work strengthened. However, those in couples with children whose partner works have seen their PTRs increase on average as a result of Labour’s reforms. These effects can both chiefly be put down to the extension of in-work support for low-income families with children: namely, the introduction of the working families’ tax credit in 1999 and its replacement with the working tax credit in 2003. While these reforms have strengthened the incentive for lone parents to work and the incentive for couples with children to have one earner rather than none, they have weakened the incentive for couples with children to have two earners rather than one.

Table 4.1. Mean PTRs for different groups under 1997, 2001, 2005 and 2010 tax and benefit systems (%)

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Single, no children</td>
<td>57.5</td>
<td>55.4</td>
<td>55.8</td>
<td>56.2</td>
<td>58.7</td>
<td>55.9</td>
<td>55.6</td>
<td>56.2</td>
</tr>
<tr>
<td>Lone parent</td>
<td>69.9</td>
<td>65.8</td>
<td>65.2</td>
<td>63.7</td>
<td>66.0</td>
<td>64.3</td>
<td>64.3</td>
<td>63.7</td>
</tr>
<tr>
<td>Couple with kids, partner works</td>
<td>44.3</td>
<td>42.4</td>
<td>47.4</td>
<td>49.0</td>
<td>45.9</td>
<td>45.5</td>
<td>47.4</td>
<td>49.0</td>
</tr>
<tr>
<td>Couple with kids, partner no work</td>
<td>70.5</td>
<td>67.8</td>
<td>69.5</td>
<td>67.4</td>
<td>70.2</td>
<td>67.7</td>
<td>69.1</td>
<td>67.4</td>
</tr>
<tr>
<td>Couple w/out kids, partner works</td>
<td>43.2</td>
<td>41.5</td>
<td>43.6</td>
<td>43.5</td>
<td>42.8</td>
<td>41.2</td>
<td>43.8</td>
<td>43.5</td>
</tr>
<tr>
<td>Couple w/out kids, partner no work</td>
<td>58.8</td>
<td>57.4</td>
<td>60.0</td>
<td>58.5</td>
<td>58.9</td>
<td>57.6</td>
<td>59.7</td>
<td>58.5</td>
</tr>
</tbody>
</table>

Notes: As for Figure 4.1. Sources: As for Figure 4.1.

The incentive to progress in work

Table 4.2 shows the mean METR for each group under the current 2010 system, and simulated mean METRs under suitably uprated 1997, 2001 and 2005 systems. We again only include workers in this analysis.
Table 4.2. Mean METRs for different groups under 1997, 2001, 2005 and 2010 tax and benefit systems, workers only (%)

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Single, no children</td>
<td>49.1</td>
<td>49.2</td>
<td>51.1</td>
<td>51.1</td>
<td>48.8</td>
<td>49.2</td>
<td>51.2</td>
<td>51.1</td>
</tr>
<tr>
<td>Lone parent</td>
<td>67.0</td>
<td>65.8</td>
<td>68.8</td>
<td>69.8</td>
<td>68.5</td>
<td>65.3</td>
<td>68.4</td>
<td>69.8</td>
</tr>
<tr>
<td>Couple with kids, partner works</td>
<td>45.5</td>
<td>47.1</td>
<td>50.5</td>
<td>51.3</td>
<td>45.7</td>
<td>47.7</td>
<td>50.4</td>
<td>51.3</td>
</tr>
<tr>
<td>Couple with kids, partner no work</td>
<td>59.5</td>
<td>60.4</td>
<td>63.6</td>
<td>64.4</td>
<td>62.3</td>
<td>62.0</td>
<td>63.0</td>
<td>64.4</td>
</tr>
<tr>
<td>Couple w/out kids, partner works</td>
<td>47.1</td>
<td>47.6</td>
<td>48.9</td>
<td>48.5</td>
<td>46.5</td>
<td>47.4</td>
<td>49.1</td>
<td>48.5</td>
</tr>
<tr>
<td>Couple w/out kids, partner no work</td>
<td>50.2</td>
<td>51.3</td>
<td>55.0</td>
<td>54.6</td>
<td>49.7</td>
<td>51.2</td>
<td>54.7</td>
<td>54.6</td>
</tr>
</tbody>
</table>

Notes: As for Figure 4.3.
Sources: As for Figure 4.3.

We can see that Labour’s tax and benefit reforms have acted to weaken the incentive for all groups to progress, with relatively little variation. One variation that is apparent is that the cut in the basic rate of income tax in April 2008 has reduced METRs on average for those without children, while METRs for those with children have increased on average as a result of reforms since 2005. This is because the effect of the cut in the basic rate of income tax has been more than offset by the extension of means-tested benefits and tax credits to more people with children, meaning that more would be subject to the steep withdrawal of these if they were to increase their earnings slightly.

4.3 Summary

Overall, Labour’s reforms have slightly weakened the incentive to work at all and the incentive for workers to increase their earnings slightly. In particular, the incentive for couples to have two earners rather than one has been weakened by Labour’s reforms and there has been a large increase in the number of workers with high METRs (over 70%) as a result of the extension of in-work benefits and tax credits since 1997. However, the incentive to work at all has strengthened for those who had the weakest incentives to work, such as lone parents, and there has been a reduction in the number with extremely high METRs, of over 80%.

5. The incentive to save

In this section, we examine how tax and benefit reforms since 1997 have affected the incentive to save. Key reforms that have affected the taxation of savings include:

- the introduction of ISAs to replace PEPs and TESSAs;
- the abolition of mortgage interest tax relief for owner-occupiers;
- the abolition of the dividend tax credit for tax-exempt shareholders, including pension funds;
- reforms to capital gains tax (see Section 2.4).
The main effects of these reforms have been to reduce or eliminate distortions that encouraged individuals to save in a primary residence or a pension. Abolition of mortgage interest tax relief for owner-occupiers has meant that primary residences now have a zero effective rate of taxation (aside from council tax, which is paid by renters as well as owner-occupiers, and stamp duty land tax, which is paid on the purchase of a property). To show how these reforms have affected the incentive to save, Table 5.1 shows the effective tax rate (ETR) on saving in each of the different asset types in 1997–98 and 2010–11 – the percentage reduction in the annual real rate of return caused by tax. We assume that all assets earn a 3% real rate of return before tax and that inflation is 2% in both years.

We can see that reforms since 1997 have had a mixed record in reducing the distortions between investing in different types of asset created by the tax system. On the one hand, the introduction of ISAs has increased the opportunities for individuals to invest in tax-free vehicles, and the abolition of MIRAS has removed a subsidy for investing in a primary residence. (TESSAs, which cash ISAs replaced, only attracted tax-favourable status if savings were left in them for five years, whereas individuals are able to access cash ISA funds immediately with no tax penalty.) On the other hand, however, Labour’s reforms to capital gains tax, in removing relief for inflation, have introduced positive rates of tax on forms of saving that generate only nominal capital gains, as we are assuming here for shares held outside an ISA. If these assets had increased in value in real terms, though, there would also have been a positive tax rate caused by GGT in 1997.

### Table 5.1. Effective tax rates on different savings vehicles, 1997–98 and 2010–11

<table>
<thead>
<tr>
<th>Asset</th>
<th>Effective tax rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ISA (cash or stocks and shares)</td>
<td>n/a</td>
</tr>
<tr>
<td>Personal Equity Plan (PEP)</td>
<td>0</td>
</tr>
<tr>
<td>Tax-Exempt Special Savings Account (TESSA)</td>
<td>0</td>
</tr>
<tr>
<td>Cash deposit account</td>
<td>33</td>
</tr>
<tr>
<td>Employee pension contribution</td>
<td>(invested 10 years)</td>
</tr>
<tr>
<td></td>
<td>(invested 25 years)</td>
</tr>
<tr>
<td>Stocks and shares(^a)</td>
<td>(invested 10 years)</td>
</tr>
<tr>
<td></td>
<td>(invested 25 years)</td>
</tr>
<tr>
<td>Primary residence(^b)</td>
<td>(invested 10 years)</td>
</tr>
<tr>
<td></td>
<td>(invested 25 years)</td>
</tr>
<tr>
<td></td>
<td>(-25)</td>
</tr>
<tr>
<td></td>
<td>(-10)</td>
</tr>
<tr>
<td></td>
<td>(-15)</td>
</tr>
<tr>
<td></td>
<td>(-11)</td>
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<td></td>
<td>(-21)</td>
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<td></td>
<td>(-8)</td>
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<td></td>
<td>0</td>
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<td></td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>7</td>
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<tr>
<td></td>
<td>0</td>
</tr>
</tbody>
</table>

\(^a\) We have assumed capital gains that match price inflation, and real returns that accrue as interest or dividends. We assume that a capital gains tax liability is incurred.

If there were no capital gains tax incurred (for example, because capital gains do not exceed the threshold for CGT), then the ETR would be 0 regardless of the duration of the investment, since (after accounting for dividend tax credits) interest/dividends on stocks is effectively untaxed for a basic-rate taxpayer.

\(^b\) We have assumed that when an extra pound is invested in housing, half of this is funded through an interest-only mortgage, and that the value of the mortgage is below the mortgage interest relief threshold and this relief is claimed against the basic rate of income tax.

Source: M. Wakefield, *How Much Do We Tax the Return to Saving?*, Briefing Note no. 82, Institute for Fiscal Studies, London, 2009 (http://www.ifs.org.uk/bns/bn82.pdf). Wakefield gives rates for 2008–09; reforms since then that are in effect in April 2010 have had no effect on these rates.

However, two caveats to these findings are needed:

- First, we do not include corporate taxes or the dividend tax credit that was received by pension funds and other exempt taxpayers prior to 1997 in these calculations. By abolishing the

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\(^{30}\) For more detail of methodology and results, see M. Wakefield, *How Much Do We Tax the Return to Saving?*, Briefing Note no. 82, Institute for Fiscal Studies, London, 2009 (http://www.ifs.org.uk/bns/bn82.pdf).
dividend tax credit paid to pension funds, Labour’s reforms have clearly reduced the rate of return to pension saving (although as this was already tax-favoured in 1997–98 because of the 25% tax-free lump sum that can be withdrawn from pensions on retirement, it was arguably a move towards neutrality).

- Second, the rates outlined in Table 5.1 assume no eligibility for means-tested benefits. Labour’s reforms have extended eligibility to means-tested benefits and tax credits to a much larger proportion of the population. As with our analysis of work incentives, we must take into account the effect of saving on means-tested benefit and tax credit entitlement: if savings reduce entitlement to these, then this adds to the effective tax rate on saving. The asset rules in means-tested benefits, combined with their high withdrawal rates, create a very strong disincentive for those who are on means-tested benefits, or consider themselves likely to be eligible for them in the future, to build up financial assets worth more than £10,000. The government has increased this limit from £3,000 since 2005, strengthening the incentive to save for those who were already entitled to means-tested benefits (or would have anticipated that they would be in the future), but by increasing the number of individuals who are entitled, Labour’s reforms have weakened the incentive to save for many individuals.\

To summarise, policy reforms since 1997 have had a mixed record in reducing distorting differences in the tax treatment of different forms of saving. Tax-free savings vehicles have been expanded, and tax relief for mortgage interest for homeowners has been abolished, eliminating a distortion in favour of saving in a primary residence. But Labour’s capital gains tax reforms have reduced the attractiveness of investing in shares outside an ISA or pension fund when only nominal capital gains are accrued, and encouraged small business owners to invest in their own businesses. Also, the extension of means-tested benefits has weakened the incentive to save for many individuals.

6. Conclusion

Labour’s reforms since 1997 have represented a net takeaway of £7.1 billion relative to the ‘unchanged policy’ baseline used by the Treasury in Budgets and Pre-Budget Reports, or a net takeaway of £36.4 billion relative to a baseline where all tax thresholds and benefit rates are increased in line with GDP per capita.

Relative to the conventional Treasury baseline, these reforms have been highly progressive – the poorest three-fifths of households have gained on average, while the richest two-fifths have seen their incomes reduced on average.

Relative to a baseline of GDP-indexation, while the reforms have still been progressive, only the poorest three-tenths of households have gained on average from the reforms (and by only a little), while the richest seven-tenths have lost out.

Most of these effects have been the result of reforms during Labour’s first two terms – reforms since 2005 that are in place by April 2010 have had relatively little effect on any except the richest

31 Tax credit entitlement is assessed on the same measure of income as income tax; so saving in ISAs, pensions and owner-occupied housing is not discouraged by tax credit withdrawal, while other forms of savings income are counted for the means test and reduce tax credit entitlement. Means-tested benefits treat assets in a completely different way. Owner-occupied housing is disregarded, as for income tax and tax credits; pension income is counted, but unlike for income tax and tax credits, only half of pension contributions are deducted from income. For other savings – ISAs receive no special treatment – the actual income generated is disregarded; however, if the total value of these assets is above £6,000, every £250 (£500 for those aged 60 or over) of savings above this level is assumed to give an income of £1 per week for the purposes of the means test, and those with assets of more than £16,000 are not eligible for means-tested benefits at all. For those aged 60 or over, the lower limit is £10,000 rather than £6,000 and there is no upper limit.
2% of individuals, who have significantly lost out from income tax changes introduced in April 2010.

Looking at redistribution between different family types, the main beneficiaries from tax and benefit reforms since 1997 have been low-income families with children and pensioners who are receiving tax credits and/or means-tested benefits. Those of working age without children, and those with children on higher incomes, have tended to lose, on average.

On average, tax and benefit reforms since 1997 have tended to weaken both the incentive for individuals to work at all and the incentive for them to increase their earnings slightly. In particular, the incentive for couples to have two earners rather than one has been weakened by Labour’s reforms and there has been a large increase in the number of workers with high marginal effective tax rates (METRs) (over 70%) as a result of the extension of in-work benefits and tax credits. However, the incentive to work at all has strengthened for those who had the weakest incentives to work to begin with, such as lone parents, and there has been a reduction in the number with extremely high METRs, of over 80%.

Policy reforms since 1997 have had a mixed record in reducing distorting differences in the tax treatment of different forms of saving. Tax-free savings vehicles have been expanded, and tax relief for mortgage interest for homeowners has been abolished, eliminating a distortion in favour of saving in a primary residence. But Labour’s capital gains tax reforms have reduced the attractiveness of investing in shares outside an ISA or pension fund when only nominal capital gains are accrued, and encouraged small business owners to invest in their own businesses. Also, the extension of means-tested benefits has weakened the incentive to save for many individuals.

Appendix: Methodological details

We use the IFS tax and benefit microsimulation model, TAXBEN, to calculate taxes due and entitlements to benefits for a representative sample of households, making use of data on incomes, expenditures and household demographic characteristics. Because TAXBEN models households’ entitlement to programmes, not their actual receipt, we cannot account for non-take-up (nor fraudulent or erroneous claims). Because non-take-up and fraud work in opposite directions, and because changes in these things may relate to government action (e.g. advertising campaigns), we cannot be sure of the size or even the direction of any bias this may induce in our estimates. However, it is reassuring that our estimates of total receipts from income tax and NI and total benefit expenditure are very close to government administrative data.

Our analysis nearly always assumes no behavioural response to tax and benefit reforms (modelling all behavioural change would be intractable and, in any case, it is not clear that an analysis that includes behavioural change is a better way of thinking about how tax and benefit changes have affected households). For instance, if work incentives were stronger in the past, we do not account for the (likely) extra work people would have undertaken today if there had not been changes to the tax and benefit system. We also have to make assumptions about the true incidence of tax reforms.

32 We use the 2006–07 Family Resources Survey to model changes in direct tax (e.g. income tax) and benefits and the 2007 Expenditure and Food Survey to model changes in taxes on consumer spending (e.g. VAT).

33 This is because individuals will change their behaviour in response to tax and benefit reforms in a way that improves their welfare relative to what they would have received if they had left their behaviour unchanged. But there must also be a welfare cost to this, otherwise they would have behaved differently before the reform was enacted. Therefore, the change in cash payments assuming no behavioural response is always an upper bound of the welfare cost of a tax change in cash terms, while the change in cash payments allowing for behavioural response is always a lower bound. It is ambiguous which will be a better estimate of the true welfare cost.
We assume that, for direct taxes and benefits, the actual incidence is the same as the formal incidence, i.e. income taxes are incident on the individuals who are legally obliged to pay them. This means that, for example, if income tax increases, we do not allow for the potential that the employer may pay slightly higher wages to partly compensate their workers (which would mean that the owners, customers or other employees of the firm would bear part of the economic cost of the tax increase). One exception is that changes in employers’ NI are ultimately borne by workers in the form of lower gross wages. We do this because the economic impact of employers’ and employees’ NI should be identical. Employers may formally pay employers’ NI, but this does not necessarily mean that the owners of firms are ultimately made worse off by it. For indirect taxes, we assume that changes to tax rates are fully passed on to consumers in the form of price changes.