The Institute for Fiscal Studies

# ELECTION BRIEFING 2001

*Edited by*
*Tom Clark*
*Andrew Dilnot*

Commentary No. 84
May 2001

# Election Briefing 2001

# May 2001

**Nicholas Bloom**
**Stephen Bond**
**Mike Brewer**
**Tom Clark**
**Andrew Dilnot**
**Carl Emmerson**
**Christine Frayne**
**Alissa Goodman**
**Alexander Klemm**
**Michal Myck**
**Howard Reed**
**Helen Simpson**
**Zoë Smith**
**Matthew Wakefield**

*and*

**Judith Payne (copy-editing)**

*Editors:* **Tom Clark and Andrew Dilnot**

**The Institute for Fiscal Studies**
**7 Ridgmount Street**
**London WC1E 7AE**

**Published by**

The Institute for Fiscal Studies
7 Ridgmount Street
London WC1E 7AE
Tel: +44-20-7291 4800
Fax: +44-20-7323 4780
Email: mailbox@ifs.org.uk
Internet: http://www.ifs.org.uk



ISBN1-903274-01-X

**Printed by**
KKS Printing, London

Support from the ESRC-funded Centre for Fiscal Policy at IFS is gratefully acknowledged.

# Contents


| | | |
|---|---|---|
| **1** | **Introduction** | **1** |
| | **Part I: The 1997–2001 Parliament** | **5** |
| **2** | **Overall tax and spending** | **7** |
| 2.1 | Public borrowing and the fiscal rules | 7 |
| 2.2 | Why have tax revenues increased? | 11 |
| 2.3 | What has happened to public spending? | 16 |
| **3** | **Spending on public services** | **18** |
| 3.1 | Spending on the NHS | 18 |
| 3.2 | Spending on education | 21 |
| 3.3 | Other areas of government spending | 23 |
| **4** | **Living standards under Labour** | **28** |
| 4.1 | What has happened to average incomes? | 28 |
| 4.2 | What has happened to the gap between rich and poor? | 29 |
| 4.3 | What has happened to poverty? | 33 |
| 4.4 | Conclusions | 36 |
| **5** | **Fiscal reforms affecting households, 1997–2001** | **37** |
| 5.1 | The scope of the analysis | 37 |
| 5.2 | The pattern of tax reform | 38 |
| 5.3 | Effect of reforms on household incomes | 42 |
| 5.4 | Other taxes directly paid by households | 46 |
| 5.5 | Employer National Insurance reform | 48 |
| 5.6 | Conclusions | 50 |
| **6** | **Labour and business taxes** | **51** |
| 6.1 | Taxes on corporate profits | 51 |
| 6.2 | Tax measures for smaller companies | 55 |
| 6.3 | Windfall tax | 57 |
| 6.4 | Climate change levy | 57 |
| | **Part II: Election 2001** | **59** |
| **7** | **The main parties' tax and spending proposals** | **61** |
| 7.1 | Plans for public borrowing | 61 |
| 7.2 | Tax and spending: how big is the choice on offer? | 62 |
| 7.3 | Spending on the NHS | 64 |
| 7.4 | Spending on education | 67 |
| 7.5 | Social security spending | 69 |
| 7.6 | Other areas of government spending | 70 |

| | | |
|---|---|---|
| **8** | **The Conservatives' proposals** | **71** |
| 8.1 | Tax cuts for families | 71 |
| 8.2 | A tax cut for savers | 74 |
| 8.3 | Extra help for pensioners | 76 |
| 8.4 | In-work benefit reform | 77 |
| 8.5 | Cutting fuel duty | 79 |
| 8.6 | The overall effects of the reforms | 80 |
| 8.7 | Additional Conservative tax proposals | 82 |
| 8.8 | Conservative long-term aspirations | 82 |
| 8.9 | Conclusions on Conservative tax and benefit proposals | 83 |
| 8.10 | Can the Conservatives cut spending by £8bn? | 84 |
| 8.11 | Conclusions on Conservative spending proposals | 88 |
| **9** | **The Liberal Democrat proposals** | **89** |
| 9.1 | Tax-raising measures | 89 |
| 9.2 | Benefit increases | 91 |
| 9.3 | Distributional effect | 93 |
| 9.4 | Longer-term aspirations | 95 |
| 9.5 | Conclusions | 97 |
| **10** | **Labour's proposals** | **98** |
| 10.1 | Three new credits | 98 |
| 10.2 | Asset-based welfare | 101 |
| 10.3 | Labour policy on income tax | 108 |
| 10.4 | Conclusions | 110 |
| **11** | **The structure of welfare** | **112** |
| 11.1 | Welfare policy proposals | 112 |
| 11.2 | Generosity of state support | 113 |
| 11.3 | Extending means testing and eroding the contributory principle | 116 |
| 11.4 | Extending joint assessment and joint taxation | 123 |
| 11.5 | The benefit system and workless claimants | 125 |
| | Appendix A: Should we let people opt out of the basic state pension? | 129 |
| | Appendix B: Public spending: What are the options beyond March 2004? | 134 |

# 1. Introduction

This Commentary offers economic analysis of the last Parliament and assesses some of the choices that the main political parties are offering the British public in the 2001 election.

# Part I: The 1997–2001 Parliament

## Overall tax and spending *(Chapter 2)*

Between 1996–97 and 2000–01, government revenues have risen by 2.9% of GDP from 37.6% to 40.5%, while spending has decreased from 41.2% of GDP to 38.8%. As a consequence, over this four-year period, public sector net borrowing fell by a total of 5.3% of GDP, moving from large deficit to large surplus.

**Changes in taxation and spending, different periods**

| | Annualised average real increase (%) | |
|---|---|---|
| | **Total taxes** | **Total spending** |
| **Comparisons across Parliaments** | | |
| This Parliament: *April 1997 to March 2001* | 4.8 | 1.3 |
| Last Parliament: *April 1992 to March 1997* | 2.0 | 2.0 |
| Conservative years: *April 1979 to March 1997* | 1.8 | 1.7 |
| **Other periods of interest** | | |
| Current plans: *April 2001 to March 2004* | 1.5 | 3.8 |
| First two years of this Parliament: *April 1997 to March 1999* | 4.5 | –1.0 |
| Five-year increase from start of first CSR: *April 1999 to March 2004* | 2.9 | 3.8 |

Source: Chapter 2.

The table shows the movements in taxation and spending seen since 1979. During the Conservative years, the economy grew at an average of 2.1% per year, implying that both tax and public spending fell as a share of national income. In the last four years, taxes have risen as a share of national income but spending has fallen. Part of this is explained by a rapidly growing economy, which tends to boost taxation receipts and depress spending.

## Spending on public services *(Chapter 3)*

Although overall public spending has grown slowly in the last four years, spending in some areas – most notably health and education – has grown significantly more rapidly than in the 18 years of Conservative government that preceded this Parliament. This has been possible in spite of an overall reduction in spending as a share of national income because of particularly slow growth in social security spending and a reduction in debt interest payments.

Public spending grew significantly more quickly in the last year of the Parliament than in the previous three, and is planned to grow quite rapidly over the next three years.

Public sector investment spending, which had fallen in the years before the last election, has fallen further as a share of national income and in real terms, despite the government's intention to increase it.

## Living standards under Labour *(Chapter 4)*

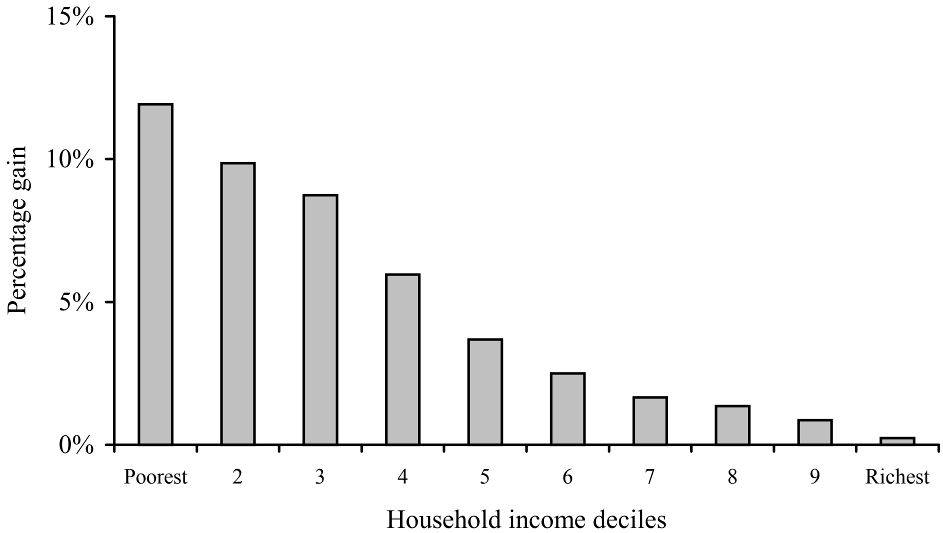
Actual living standards are the result of not just changes to the tax and benefit system, but also changes to the underlying distribution of income. Data to examine this are only available for the first three years of the Labour government.

During this period, the incomes of the poorest fifth of households grew at an average annual rate of 1.4%, with subsequent fifths growing respectively at 1.5%, 1.8%, 2.4% and 2.8%. Although the direct effect of government measures was to reduce inequality, the underlying distribution of income widened by enough to more than offset the effects of tax and benefit changes in the first three years of the Parliament.

## Fiscal reforms affecting households *(Chapter 5)*

We have modelled the impact of changes to the tax and benefit system as it affects households. Many of the tax increases seen in recent years cannot readily be included, most notably the increased taxation on company incomes and pension fund dividends. We have assumed in these calculations that all entitlements to means-tested benefits are taken up, which they are not, which

**Effect of major fiscal reforms implemented July 1997 to June 2001**




Note: The first decile contains the poorest 10% of the population, while the tenth decile contains the richest 10%.
Source: Chapter 5.

should be borne in mind in interpreting the results. The broad pattern of the results is unaffected by this.

The figure shows gains concentrated on lower incomes. The substantial gains at the bottom end are mainly a result of higher means-tested benefits, especially for pensioners and families with children. Reforms to National Insurance contributions have also helped those on lower earnings. It is important to remember that while, *on average*, families in each decile gain, some families within each decile lose from the reforms, often because of indirect taxes.

### Labour and business taxes *(Chapter 6)*

The Labour government has cut the main corporation tax rate from 33% to 30%, abolished advance corporation tax, removed repayable dividend tax credits from pension funds, and moved to a quarterly system of tax payments for large firms. The combined effect of these changes has been to raise significant revenue during this Parliament, but in a way that is largely temporary, giving a boost to revenues during the Parliament just ending which will not be available in the longer term.

# Part II: Election 2001

### The main parties' tax and spending proposals *(Chapter 7)*

The Conservatives advocate spending and tax cuts of around £8bn per year relative to Labour's plans, the Liberal Democrats increases of similar size. These differences represent less than 1% of GDP, which raises the question of what the longer-term plans of all the parties are.

### The Conservatives' proposals *(Chapter 8)*

Tax cut proposals focus on savers, single-earner couples with children and petrol. The largest proportionate gains go to families in the middle of the income distribution. Spending cuts of £8bn are proposed to finance the tax reductions, which we analyse.

### The Liberal Democrat proposals *(Chapter 9)*

The main source of revenue to fund higher public spending for the Liberal Democrats is higher income tax, both the basic rate and a new higher rate of 50%. The new spending is targeted on education, pensioners and health. The overall package increases the average incomes of poor households and reduces those of the better-off.

### Labour's proposals *(Chapter 10)*

There is little new proposed on tax structure, but there is confirmation of some proposed welfare reforms. The new credits for pensioners, childless people on low pay and families with children would extend the means-testing approach seen in the last Parliament. Ideas for asset-based welfare are also introduced, although await further detail.

## The structure of welfare *(Chapter 11)*

If Labour were to win the election, we seem likely to see the shift to means-tested, credit-type schemes taken further. This shift has already increased the incomes of the poorest, extended joint assessment of incomes and furthered the erosion of the contributory principle. The other two main parties both challenge this approach, emphasising the problems of means testing.

# 2. Overall tax and spending

This chapter looks at the current government's record on public borrowing, taxation and overall public spending.

## 2.1 Public borrowing and the fiscal rules

Since coming to office in May 1997, the government has stated that it will aim to adhere to two fiscal rules – the 'golden rule' and the sustainable investment rule – when planning levels of taxation and public spending. The golden rule states that the government should only borrow to invest. It constrains the government to running a surplus on the current budget over the economic cycle – in other words, over the economic cycle, government revenues will exceed current spending: any overall deficit must be smaller than investment spending.

The sustainable investment rule places a constraint on the level that government debt can reach, restricting it to a 'stable and prudent' level,[1] which the Chancellor Gordon Brown has defined as 40% of GDP. The aim is to avoid what the government considers to be unfairly high debt interest payments in the future.[2]

According to government projections for both taxes and spending, both the fiscal rules look set to be met. Figure 2.1 shows the surplus on current budget and the cyclically adjusted surplus on current budget from 1966–67 to 2003–04. It shows that the golden rule has been met since 1998–99 and is set to continue being met until 2003–04, when the cyclically adjusted surplus on current budget is predicted to be 0.6% of GDP. Under currently planned levels of investment, meeting the golden rule is sufficient to ensure that the sustainable investment rule is met.

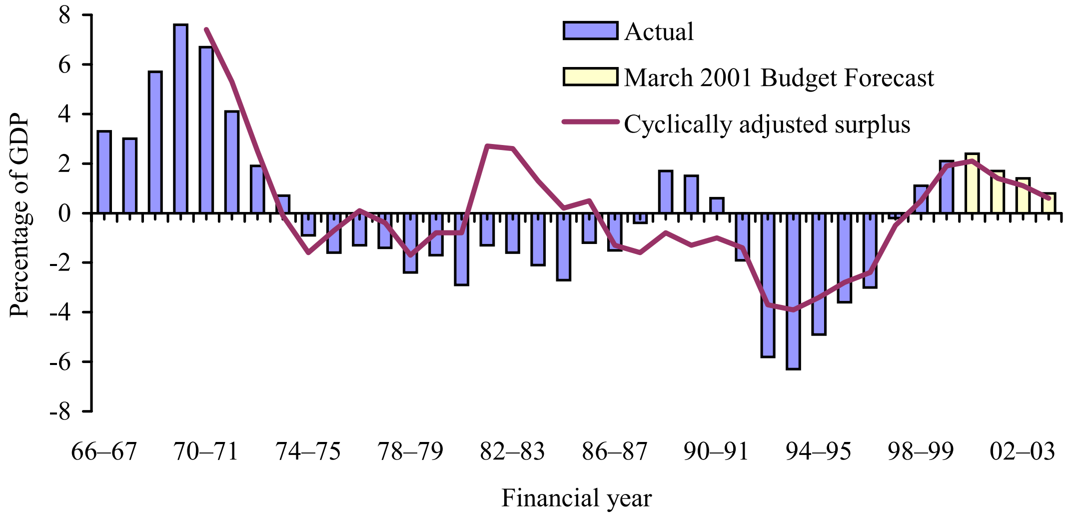
The level of public sector net borrowing can be seen in Figure 2.2 as the amount by which spending lies above government revenues. Thus, between 1990–91 and 1997–98, public sector net borrowing was positive due to spending being higher than receipts, while, since 1998–99, receipts have been higher than spending, leading to negative borrowing – or debt repayment. The government has been in deficit for most of the last thirty years. Indeed, between 1970–71 and 1998–99, the government was only in surplus in 1988–89 and 1989–90, when the economy was operating at above-trend levels of output.

---

[1] Source: HM Treasury, *Economic and Fiscal Strategy Report, June 1998*, Cm. 3978, The Stationery Office, London, 1998 (http://www.hm-treasury.gov.uk/pub/html/efsr/3978.htm).

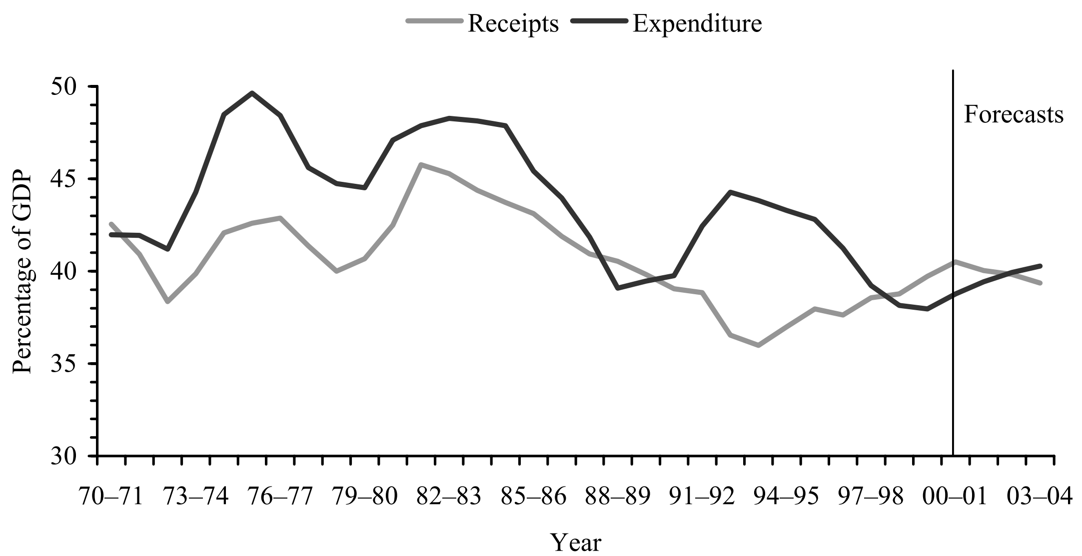
[2] For a more detailed discussion of the fiscal rules, see C. Emmerson and C. Frayne, *The Government's Fiscal Rules*, IFS Briefing Note no. 16, 2001 (http://www.ifs.org.uk/public/bn16.pdf).

**Figure 2.1. Meeting the golden rule? Current budget surpluses and deficits as a percentage of GDP, 1966–67 to 2003–04**




Note: Measures exclude the windfall tax and associated spending.
Source: HM Treasury, *Public Finances Databank, 22 March 2001*, HM Treasury, London, 2001.

**Figure 2.2. Taxation and spending under current government plans, 1970–71 to 2003–04**




Note: Measures exclude the windfall tax and associated spending.
Sources: Forecast for 2001–02 to 2003–04 taken from HM Treasury, *Financial Statement and Budget Report, March 2001*, Hc279, The Stationery Office, London, 2001 (http://www.hm-treasury.gov.uk/budget2001/index.html); HM Treasury, *Public Finances Databank, 22 March 2001*, HM Treasury, London, 2001.

The recession of the early 1990s meant that, by 1993–94, public sector net borrowing had reached 7.8% of GDP. Since then, spending restraint and tax increases pursued by the Conservatives after 1993–94 and continued by Labour in the first three years of this Parliament have put the public finances back into surplus. Figure 2.2 shows government revenues and government spending as a proportion of GDP. Between 1996–97 and 2000–01, government revenues have risen by 2.9% of GDP from 37.6% of GDP to 40.5% of GDP, while spending has decreased by 2.5 percentage points – from 41.2% of GDP in 1996–97 to 38.8% by 2000–01. This means that, over four years, public sector net borrowing fell by a total of 5.3% of GDP.[3] While the forecasts suggest that the government will move back into deficit by 2003–04, this is still consistent with the two fiscal rules, since borrowing is planned to be less than investment spending and the net debt ratio is planned to be comfortably below 40% of GDP.

Table 2.1 breaks down the movements in taxation and spending since 1979. Overall under the Conservatives from 1979 to 1997, taxes increased in real terms by 1.8% a year on average, while overall spending increased by an average of 1.7% a year, again in real terms. Both of these numbers correspond to a decrease in taxation and spending as a share of GDP, as the economy grew on average by 2.1% during this period. Since taxes increased more quickly than public spending, there was a small reduction in public sector net borrowing over the period.

**Table 2.1. Changes in taxation and spending, different periods**

| | **Annualised average real increase (%)** | |
|---|---|---|
| | **Total taxes** | **Total spending** |
| **Comparisons across Parliaments** | | |
| This Parliament: *April 1997 to March 2001* | 4.8 | 1.3 |
| This Parliament: *April 1997 to March 2002* | 4.1 | 1.9 |
| Last Parliament: *April 1992 to March 1997* | 2.0 | 2.0 |
| Conservative years: *April 1979 to March 1997* | 1.8 | 1.7 |
| *of which:* | | |
| John Major's period in office: *April 1991 to March 1997* | 1.3 | 2.6 |
| Margaret Thatcher's period in office: *April 1979 to March 1991* | 2.0 | 1.2 |
| **Other periods of interest** | | |
| Current plans: *April 2001 to March 2004* | 1.5 | 3.8 |
| First two years of this Parliament: *April 1997 to March 1999* | 4.5 | –1.0 |
| Five-year increase from start of first CSR: *April 1999 to March 2004* | 2.9 | 3.8 |

Notes: Measures exclude the windfall tax and associated spending. For the periods in office of each political party and each Prime Minister, we assign financial years according to who was in office for the majority of months in that financial year. For example, Margaret Thatcher, who was Prime Minister from May 1979 to November 1990, is assumed to have determined public spending in the years from 1979–80 to 1990–91 inclusive.
Sources: HM Treasury, *Public Finances Databank, 22 March 2001*, HM Treasury, London, 2001; HM Treasury, *Financial Statement and Budget Report, March 2001*, Hc279, The Stationery Office, London, 2001 (http://www.hm-treasury.gov.uk/budget2001/index.html).

[3] These and other figures are subject to rounding errors.

By the end of 2000–01, taxes had increased by an average 4.8% a year since Labour came to power in 1997, with a corresponding average increase in spending of just 1.3% a year. It is worth noting that, while the government is now taking a larger proportion of GDP in tax, GDP growth has been sufficiently strong to ensure that the private sector's net income is forecast to have grown in real terms by an average of 1.7% a year between April 1997 and March 2001. The first two years of the Labour government saw taxes increase by 4.5% per year, while spending fell by an average of 1.0%. This led to the improvement in public sector net borrowing shown in Figure 2.2 and the golden rule being met, as shown in Figure 2.1.

As a result of the improvement in the public finances being more than sufficient to meet the government's fiscal rules, the current government has been able to plan for spending over the next three years to grow significantly more quickly than tax revenues. From April 2001 to March 2004, taxes are forecast to grow by just 1.5% a year in real terms, while public spending is forecast to grow by an average 3.8% a year. Essentially, this relatively low growth in taxes and high growth in public spending is being paid for by the high growth in taxes and low growth in public spending seen over the period from April 1997 to March 2000, when taxes increased by 2.2% of GDP while spending fell by 3.3% of GDP.

These estimates are based on the Treasury's cautious assumption that the economy can sustain 2¼% trend growth. It is possible that the trend rate of growth could be higher. The Treasury's own central forecast of the trend rate of growth is 2½% a year.[4] Moreover, one of the Treasury's performance targets is 'By 2004, to raise the trend rate of growth from the current estimate of 2.5%'.[5] Were the trend rate of growth to be greater than 2¼%, the next Chancellor would be in a position to implement discretionary tax cuts or spending increases. For example, if the actual trend rate of growth between 2000–01 and 2003–04 were 2½% a year, this would allow a fiscal loosening of £4½bn, while 2¾% would allow as much as £9bn.[6]

## Risks

While the government is set to increase spending considerably over the next four years, remaining in surplus on current budget is dependent on the economy performing as forecast. In particular, if growth turns out to be lower than expected (for example, due to a world-wide recession), tax revenues are likely to be lower and cyclical spending – such as social security – higher than planned. If this turned out to be a structural, rather than a cyclical, downturn, then it is possible that the golden rule could be broken. Such an unexpected downturn occurred in the late 1980s and early 1990s, when the government

---

[4] Source: HM Treasury, *Trend Growth: Prospects and Implications for Policy*, HM Treasury, London, 2000 (http://www.hm-treasury.gov.uk/pdf/1999/trendgrowth.pdf).

[5] Source: HM Treasury, *2000 Spending Review: Public Service Agreements, July 2000*, Cm. 4808, HM Treasury, London, 2000 (http://www.hm-treasury.gov.uk/sr2000/psa/psa.pdf).

[6] Example assumes that 60% of the additional GDP arising from the increase in trend rate of growth is received in taxes.

spent the extra revenue received when the economy was growing strongly, only to suffer historically large deficits when the recession began.

But it is important to remember that the public finances are now in historically very good shape. In addition, the forecasts' cautious assumptions make it less likely that the government will find itself in an extremely difficult financial position. To argue that the UK government is not adequately prepared for a possible structural downturn is to argue that either taxes should have increased more rapidly or public spending grown more slowly over the last four years.

It seems, then, that the government is likely to be in a position where it can afford the large increases in spending planned to take effect between now and 2003–04. While these increases in spending should lead to some improvement in the quality of service provided by, for example, the NHS and local schools, unless the perceived improvements are significant, the government may feel under pressure to increase spending further as a percentage of GDP. If spending is to grow more quickly than GDP beyond 2003–04, this would require further tax increases. For example, the next government could decide that it wants to continue increasing public spending at the rate planned over the next three years of 3.8% a year. Assuming a trend rate of growth of 2½% a year, this would require tax rises of £5bn a year in 2000–01 prices over and above the additional revenues resulting from taxes remaining constant as a share of GDP. Alternatively, a future government might decide that it wanted to increase public spending at the rate originally planned in the July 2000 Spending Review of 3.3% a year. On an equivalent basis, this would still require increases in taxes of £3bn a year beyond March 2004.

# 2.2 Why have tax revenues increased?

This section looks in detail at why tax revenue as a share of GDP is higher than it was when Labour came into power in May 1997. The main conclusions are:

- Government receipts in 2001–02 are forecast to be 2.4% of GDP higher than they were in 1996–97. This is equal to £24.3bn.
- Budgetary policies implemented by this government have increased taxes by £5.7bn. The first two years of this Parliament saw larger tax increases, which have since been partially offset by tax cuts.
- Some of these policies were announced by the previous Conservative government. New policies announced and implemented by this government have actually reduced tax by £1.6bn.
- After changes to the accounting system and higher-than-expected inflation are taken into account, tax revenues in 2001–02 are forecast to be £13bn higher than they were forecast to be in the November 1996 Budget.

### How has the level of taxes changed since 1997?

Since Labour came to office, total public sector receipts as a percentage of GDP have increased by 2.9 percentage points from 37.6% to 40.5% of GDP.

This is equivalent to £27.1bn in 2000–01 prices. Taking the Parliament over the full five years to 2001–02, by which time Budget measures for this financial year will be fully effective, the latest forecasts suggest that the equivalent increase is 2.4 percentage points, which, in 2001–02, is equal to £24.3bn. The share of GDP taken in tax can increase either because of discretionary government policy or because of changes to the overall economy with the tax system in place. For instance, strong economic growth increases income tax revenues, corporation tax revenues and capital gains tax receipts by more than GDP growth, leading to an increase in tax revenues as a share of GDP without any discretionary changes by the government.

More than half the increase in total tax revenues since 1996–97 is made up of higher income tax receipts. Table 2.2 shows that, while the government received income tax and capital gains tax revenues equal to 9.1% of GDP in 1996–97, by 2000–01 this had increased to 11.1 percentage points. By next financial year, this is expected to fall to 10.7 percentage points. Interestingly, despite significant increases in the rates of excise duties levied on fuel and tobacco, their combined effect has not been to increase the amount of revenues received by the government expressed as a share of national income.[7]

**Table 2.2. Tax revenues as a percentage of GDP, 1996–97, 2000–01 and 2001–02**

| | 1996–97 | 2000–01 | 2001–02 |
|---|---|---|---|
| Income tax and capital gains tax | 9.1 | 11.1 | 10.7 |
| Corporation tax | 3.6 | 3.4 | 3.8 |
| Value added tax | 6.1 | 6.2 | 6.2 |
| National Insurance contributions | 6.1 | 6.4 | 6.3 |
| Fuel taxes | 2.2 | 2.4 | 2.3 |
| Tobacco taxes | 1.0 | 0.8 | 0.8 |
| Alcohol taxes | 0.7 | 0.7 | 0.7 |
| Other taxes | 6.3 | 6.8 | 6.7 |
| **Net taxes and social security contributions** | **35.2** | **37.7** | **37.4** |
| Other receipts and accounting adjustments | 2.4 | 2.8 | 2.7 |
| **Total current receipts** | **37.6** | **40.5** | **40.1** |

Source: HM Treasury, *Public Finances Databank*, *22 March 2001*, HM Treasury, London, 2001.

## Alternative measures of the tax burden

The government's preferred measure of the tax burden – net taxes and social security contributions – is also shown in Table 2.2. This excludes various items that are not directly under government control, such as the revenue from public sector corporations and also adjustments for items that the government believes should score as tax credits but that, under international accounting conventions, score as public spending.[8] There are two problems with this series. First, using current receipts seems more intuitively useful since

[7] For a more detailed discussion of indirect taxes, see Section 5.2.

[8] Examples of these include the working families' tax credit and, previously, mortgage interest tax relief.

deducting total spending from this measure leaves public sector net borrowing. Second, even if we would otherwise accept that the working families' tax credit (WFTC) should be counted as negative tax rather than spending, the inconsistency arising from treating its predecessor, family credit, differently from WFTC makes it a less informative measure. The adjustment for tax credits explains the majority of the increase in 'other receipts and accounting adjustments' seen since 1996–97.

The government has also pointed to the fact that 'the direct tax burden on a typical family with two children will fall in 2001–02 to its lowest level since 1972'.[9] There are a number of problems with this measure of the 'tax burden'. First, it is very difficult to work out who constitutes a 'typical family'. Second, and more important, if there is such as thing as a 'typical family', while they may care about the total amount of tax that they pay, they are unlikely to care about the amount of direct tax that they pay. If a government decides to increase taxes by, for example, £2bn, it seems irrelevant for the purposes of the overall measure of tax revenues whether it chooses to increase income tax by £2bn or VAT by £2bn. It is more plausible that it is total tax that is of more interest to individuals than simply the increase in just one type of tax. In fact, they may care more about their disposable income after tax, which will include social security benefits such as child benefit and the basic state pension.[10]

One further comparison of the current level of tax receipts as a share of GDP is with those planned in the last Budget of the previous Parliament. This forecast tax receipts as a share of GDP through to 2001–02. Direct comparisons of the level of taxes as a share of GDP in the November 1996 Budget cannot be made against more recent figures, since the UK has, in the interim period, switched to a new accounting system which has increased measures of GDP and hence reduced, for example, tax revenues as a share of GDP.[11] Once this is taken into account, it is clear that, while the November 1996 Budget did forecast an increase in tax revenues as a share of GDP, the planned increase was smaller than that which subsequently occurred. In 2000–01, taxes were £26bn higher than forecast in the November 1996 Budget. However, inflation between 1996–97 and 2000–01 was higher than had been forecast in November 1996 – if actual inflation had been known, the estimates of nominal taxes in 2000–01 would have been higher and so the difference between the November 1996 plans and the 2000–01 outcomes would have been £6bn lower. Hence the real increase in taxes is £20bn. For 2001–02, the real increase in taxes falls to £13bn, as reductions in taxation, such as the children's tax credit, are due to be introduced in April 2001.[12]

---

[9] Source: HM Treasury, *Financial Statement and Budget Report, March 2001*, Hc279, The Stationery Office, London, 2001 (http://www.hm-treasury.gov.uk/budget2001/index.html).

[10] For a discussion of the effect across the income distribution of all of these measures combined, see Section 5.3.

[11] See HM Treasury, *Pre-Budget Report: November 1998*, Cm. 4076, The Stationery Office, London, 1998 (http://www.hm-treasury.gov.uk/pub/html/prebudgetNov98/407600.htm).

[12] These numbers update the figures contained in Table 3.11 of A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2001*, Commentary no. 83, IFS, London, 2001 (http://www.ifs.org.uk/gbfiles/gb2001.shtml).

## What has the effect of Budget measures been on tax revenues?

The extent to which actual Budget announcements rather than changes in the economy led to the increase in taxes of £24.3bn over this Parliament is shown in Table 2.3. The table shows the total effect that Budgets in the 1987–92 and 1992–97 Parliaments had on tax revenues in the 1992–97 Parliament, and any additional effect they had in the current Parliament. Measures announced between 1992 and 1997 included the introduction of the fuel and tobacco escalators, which were to increase duty rates by more than inflation every year. These were included in the November 1996 Budget forecasts for government revenues throughout the forecast period, which ran until 2001–02. Budget measures announced during the 1992–97 Parliament meant that revenues by the end of that Parliament were £19.6bn higher than they would

**Table 2.3. Change in tax revenues in the previous Parliament and the current Parliament resulting from Budget announcements (£ billion 2001–02)**

| **Announcement** | **Last Parliament to 1996–97** | **Current Parliament to 2001–02** |
|---|---|---|
| | Effect over and above any effect on previous Parliament | |
| *Conservative Budgets from 1987–92 and 1992–97 Parliaments* | | |
| Conservative Budgets from 1987–92 Parliament | –1.8 | n/a |
| Conservative Budgets from 1992–97 Parliament | 19.6 | 7.4 |
| *Labour Budgets after the 1997 election* | | |
| Summer 1997 Budget | n/a | 5.6 |
| Spring 1998 Budget | n/a | 3.8 |
| Spring 1999 Budget | n/a | –2.5 |
| Autumn 1999 Pre-Budget Report | n/a | –4.0 |
| Spring 2000 Budget | n/a | –0.6 |
| Autumn 2000 Pre-Budget Report | n/a | –0.6 |
| Spring 2001 Budget | n/a | –3.3 |
| Total Labour Budgets during current Parliament | n/a | –1.6 |
| **Total effect of Budget changes on taxes over Parliament** | **17.9** | **5.7** |
| **Actual change in revenues over Parliament** | **–12.0** | **24.3** |

Notes: Figures stated are for the effect on revenues in 1996–97 and 2001–02 respectively. All figures have been uprated to 2001–02 prices using nominal GDP growth. Reductions to the generosity of mortgage interest tax relief that occurred in the Budgets in Spring 1993, Autumn 1993, Summer 1997 and Spring 1999 are not included since the relief counts as government expenditure rather than tax forgone in the National Accounts. Measures announced in the previous Parliament include the effect of a 5% fuel escalator and a 3% tobacco escalator. Measures announced in this Parliament include the Summer 1997 Budget decision to increase these escalators to 6% and 5% respectively and the November 1999 Pre-Budget Report decision to abolish both these escalators. Any further changes in excise duties are treated as one-off changes in the year they occurred. For more details, see A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2001*, Commentary no. 83, IFS, London, 2001 (http://www.ifs.org.uk/gbfiles/gb2001.shtml).

Sources: HM Treasury, *Financial Statement and Budget Report*, various years (most recent – http://www.hm-treasury.gov.uk/budget2001/index.html); authors' calculations.

have been in the absence of any Budget announcements.[13] Despite these increases, actual government revenues fell by 1.2% of GDP in the last Parliament; in today's prices, this is equivalent to £12.0bn. This discrepancy is explained by factors, other than taxation policy, that affect revenues, such as economic growth.

Measures announced in the 1992–97 Parliament increased revenues in 2001–02 by an additional £7.4bn. Budget announcements since 1997 have had the net effect of reducing overall tax revenues by £1.6bn, so that the overall increase in revenues directly attributable to discretionary measures announced by Labour, or by the Conservatives and implemented by Labour, is £5.7bn. In addition, this is the effect at the end of the Parliament; the first two Budgets of this Parliament increased taxes by more than this amount, before subsequent announcements reduced them. For example, if there had been no more announcements after the March 1998 Budget, then announcements in this Parliament would have increased taxes by £9.3bn on top of the £7.4bn of announced measures from the previous Parliament.

## What figure best represents the increases in taxation due to government policy?

The total effect of Budget changes on taxes over the period 1997–2002 was an increase of £5.7bn. The net effect of measures announced under Labour is a reduction of £1.6bn. Both of these numbers represent an estimate of the effect that Budget measures under Labour have had on tax revenues. Although the £5.7bn figure includes £7.4bn of increases announced by the Conservatives between 1992 and 1997, it represents the full value of the announcements made by the Conservatives and introduced by Labour as well as any new Labour policy decisions. The £1.6bn reduction due to Labour Budgets is less informative as it counts the reversal of policies announced by the Conservatives but reversed by Labour as reductions in taxation even if these policies were never actually implemented.

Arguably, the most informative measure of the increase in tax due to government policy is the £24.3bn total figure. Although this includes increases due to the workings of the economy and also partially flows from the government's chosen macroeconomic policy, it is nevertheless the case that the government could have made Budget announcements to reduce taxes in order to keep tax revenues as a share of GDP constant over time, if it had so wanted. What the current government has chosen to do is to use the increase in government revenues to reduce national debt and, from April 2000 to March 2003, to plan increases in public spending that are greater than the planned increase in taxes. The next section looks in more detail at the current government's record on public spending over the Parliament.

---

[13] Most of this increase came from the measures announced in the Spring and Autumn 1993 Budgets, which introduced VAT on fuel, higher employee National Insurance contributions, a freezing of income tax allowances and a reduction in the generosity of the married couple's allowance. These Budgets also introduced the fuel and tobacco escalators, which committed the government to increasing excise duties on fuel and tobacco in real terms by 5% and 3% respectively each year.

## 2.3 What has happened to public spending?

As we have shown, government spending is set to have increased by 1.9% per year over the period 1997–2002. This is lower than the growth seen under the Conservatives during their 18 years in office and is considerably lower than the increase in taxation seen over the current Parliament. One reason for this is that Labour's years in office have occurred at a time of high growth. From 1996–97 to 2000–01, GDP growth is forecast to have averaged around 2.9% compared with a long-run average over the last forty years of around 2.5%. High growth has reduced the need for cyclical spending, such as expenditure on unemployment benefit, thus leading to lower spending overall. Moreover, higher-than-expected revenues have allowed substantial debt repayments. This helps contain spending by lowering debt interest payments in subsequent years.

For the first two years of the Parliament, government policy worked in the same direction as the economy. When Labour came to office in May 1997 they chose to bind themselves to Conservative spending plans as outlined in Ken Clarke's November 1996 Budget, which represented historically low increases in government spending. During those first two years, total government spending fell by an average of 1.0% per year. The July 1998 Comprehensive Spending Review and the July 2000 Spending Review outlined more ambitious plans for government spending.[14] In the financial year 1999–2000, much of this planned increase in spending failed to materialise, since several government departments failed to deliver the increases in spending that had been allocated to them. In total, government departments spent £2bn less in 1999–2000 than their total allocation.[15]

The plans for government spending laid out in the July 2000 Spending Review, combined with other announcements made in the November 2000 Pre-Budget Report and the March 2001 Budget, mean that public spending is now planned to grow by 3.8% a year in real terms. Chapter 3 looks in detail at individual spending areas. We now turn to international comparisons of public spending.

### How do we compare internationally?

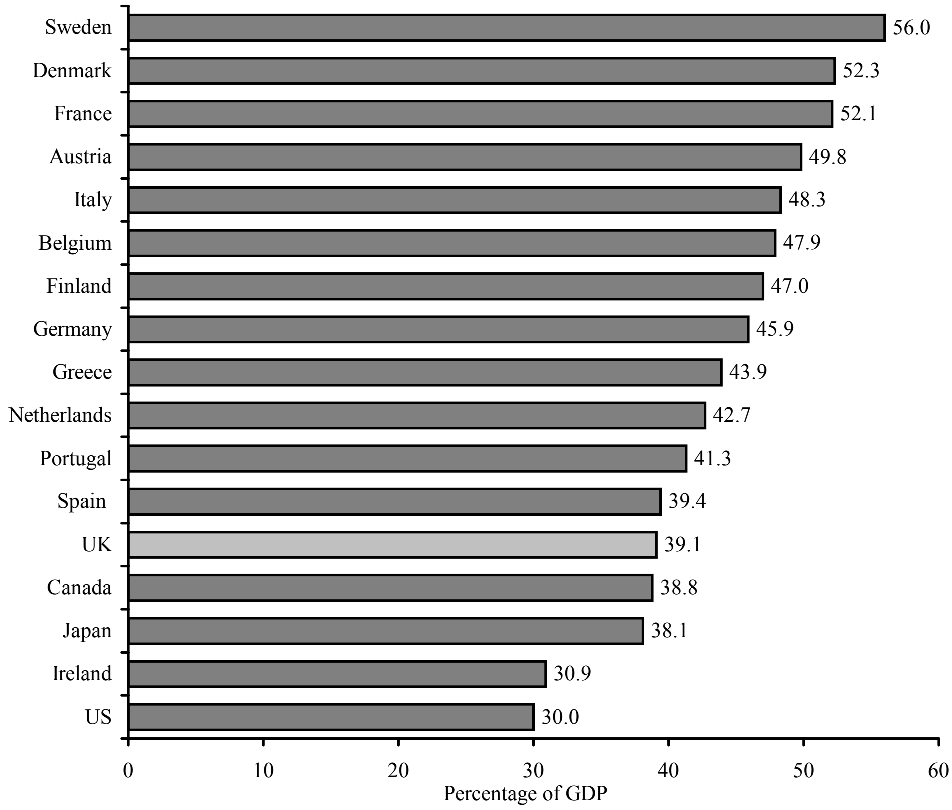
This chapter has looked at government revenues and spending over time. The size of government in the UK can also be compared with that in other countries. This can be done by looking either at government revenues as a share of GDP or at government spending as a share of GDP. Since the difference between these two series – public borrowing – is essentially

---

[14] HM Treasury, *Comprehensive Spending Review, July 1998*, HM Treasury, London, 1998 (http://www.hm-treasury.gov.uk/pub/html/csr/index.html); HM Treasury, *Spending Review 2000*, HM Treasury, London, 2000 (http://www.hm-treasury.gov.uk/sr2000/index.html).

[15] For more details, see A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2001*, Commentary no. 83, London, IFS, 2001 (http://www.ifs.org.uk/gbfiles/gb2001.shtml).

**Figure 2.3. Government spending as a percentage of GDP, 1999**




Notes: The graph gives figures for total government outlays, which equal current outlays plus net capital outlays. Figure for the US includes outlays net of surpluses of public enterprises.
Source: OECD, *Economic Outlook*, December 2000, Annex Table 28.

deferred taxation, it seems sensible to compare public expenditure rather than taxation. Compared with other EU and G7 countries, the UK has low government spending, as is shown in Figure 2.3. In 1999, general government total outlays, as measured by an OECD definition, represented 39.1% of GDP. The UK was the fifth lowest spender amongst the 17 EU (excluding Luxemburg) and G7 countries in 1999. Of the countries shown in the graph, only Canada, Japan, the Republic of Ireland and the US have lower levels of government spending. France, Denmark and Sweden all have government spending above 50% of GDP. Public spending as a share of GDP will depend in part on the point of the economic cycle that the economy is at, so it is useful to compare countries over a longer time-frame. Taking the average level of public spending over the last five years still shows the UK having the fifth lowest level of public spending out of the 17 countries shown in the graph.

*Carl Emmerson and Christine Frayne*

# 3. Spending on public services

Chapter 2 showed that public spending as a share of GDP is now lower than it was at the end of the previous Parliament. This chapter looks in detail at public spending, starting with National Health Service and education spending and comparing the increases in spending over this Parliament with the record of the previous Conservative government.

## 3.1 Spending on the NHS

The 1997 Labour Party manifesto committed the government to 'raise spending on the NHS in real terms every year'. Historically, this did not necessarily imply any difference from the increases in spending seen in the past, as, since 1979–80, the NHS has received a real increase in spending every year.[1] Despite the pledge to keep to the departmental spending plans set down in the November 1996 Budget in the first two years of the Parliament, the government did add to the NHS allocations in both 1997–98 and 1998–99.[2] This was consistent with the policy of the previous Conservative administration, which often made additional resources available to the NHS over and above its planned levels of spending.[3]

Despite these additional funds, NHS spending over the first two years of this Parliament grew by an average of just 2.2% a year in real terms – a lower increase than the 3.1% achieved over the Conservatives' 18 years in office. The July 1998 Comprehensive Spending Review set the spending plans for the next three years and allocated larger real increases in spending to the NHS for 1999–2000 to 2001–02.[4] Again, this did not necessarily mark a break from the past, since the NHS had often experienced years of lower increases in spending followed by years of larger increases in spending.

Despite the Chancellor's assertion that the 'first innovation of the Comprehensive Spending Review is to move from the short-termism of the annual cycle and to draw up public expenditure plans not on a one year basis but on a three year basis',[5] the March 2000 Budget gave the NHS a further

---

[1] C. Emmerson, C. Frayne and A. Goodman, *Pressures in UK Healthcare: Challenges for the NHS*, Commentary no. 81, IFS, London, 2000 (http://www.ifs.org.uk/health/nhsspending.pdf).

[2] Among other things, additional funds were made available in 1997–98 from a reduction in spending on defence (£168m) and on the public sector nuclear industry (£102m) and in 1998–99 from funds in the contingency reserve that were not needed (£1.2bn). For more details, see A. Dilnot and C. Giles (eds), *The IFS Green Budget: January 1998*, Commentary no. 69, IFS, London, 1998.

[3] See A. Dilnot and P. Johnson, *Election Briefing 1997*, Commentary no. 60, IFS, London, 1997.

[4] HM Treasury, *Comprehensive Spending Review, July 1998*, HM Treasury, London, 1998 (http://www.hm-treasury.gov.uk/pub/html/csr/index.html).

[5] The Chancellor's speech announcing the Comprehensive Spending Review. Source: *Hansard*, 14 July 1998, column 187.

substantial increase in resources in both 2000–01 and 2001–02. This Budget also set out NHS spending plans for 2002–03 and 2003–04, which again were added to in the recent March 2001 Budget. As a result, the spending increases seen over this Parliament do now genuinely appear to represent a break from those seen previously. As shown in Table 3.1, spending is set to increase by an average 4.8% a year over this Parliament, compared with 2.6% a year in the previous Parliament and 3.1% over the Conservatives' four terms. These increases are also considerably higher than the 3.5% average annual increases that the NHS has received over its entire history.

**Table 3.1. Real increases in NHS spending, various periods**

| | **Annualised average real increase (%)** |
|---|---|
| **Comparisons across Parliaments** | |
| This Parliament: *April 1997 to March 2001* | 4.8 |
| This Parliament: *April 1997 to March 2002* | 5.1 |
| Last Parliament: *April 1992 to March 1997* | 2.6 |
| Conservative years: *April 1979 to March 1997* | 3.1 |
| *of which:* | |
| John Major's period in office: *April 1991 to March 1997* | 3.3 |
| Margaret Thatcher's period in office: *April 1979 to March 1991* | 3.0 |
| **Other periods of interest** | |
| Current planned expenditure: *April 2001 to March 2004* | 5.7 |
| First two years of this Parliament: *April 1997 to March 1999* | 2.2 |
| Five-year increase from start of first CSR: *April 1999 to March 2004* | 6.4 |
| Highest five-year increase in history of the NHS: *April 1971 to March 1976* | 6.4 |
| Last 47 years: *April 1954 to March 2001* | 3.8 |
| History of NHS (last 51 years): *April 1950 to March 2001* | 3.5 |

Notes: NHS spending is defined here as UK National Health Service expenditure net of NHS charges and receipts. For the periods in office of each political party and each Prime Minister, we assign financial years according to who was in office for the majority of months in that financial year. For example, Margaret Thatcher, who was Prime Minister from May 1979 to November 1990, is assumed to have determined public spending in the years from 1979–80 to 1990–91 inclusive.

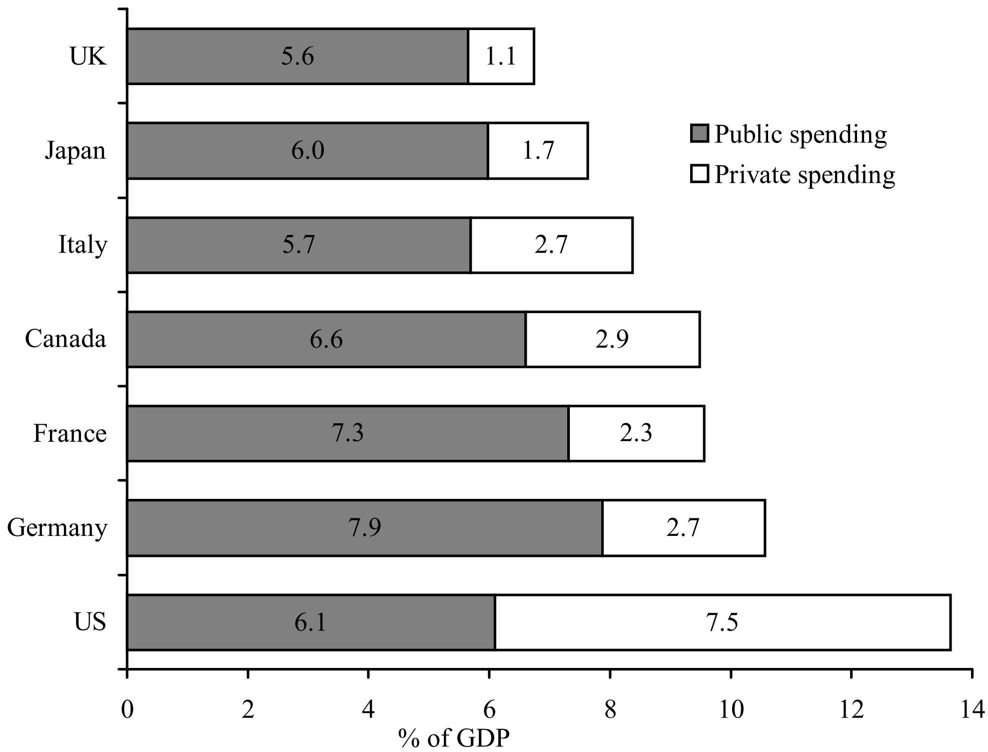
Sources: Department of Health, *The Government's Expenditure Plans*, various years (http://www.doh.gov.uk/dohreport/report2000/dr2000.html); Office of Health Economics, *Compendium of Health Statistics*, various years; HM Treasury, *Financial Statement and Budget Report, March 2001*, Hc279, The Stationery Office, London, 2001 (http://www.hm-treasury.gov.uk/budget2001/index.html). Spending figures deflated using the latest GDP deflators from the Office for National Statistics.

The planned increases in spending over the next three years to March 2004, which the current government has committed to, are set to average 5.7% a year in real terms – significantly higher than the increases seen in recent years. Interestingly, the five-year increase in spending from the start of the Comprehensive Spending Review in April 1999 is set to average 6.4% a year, which is equal to the highest-ever five-year increase that the NHS has received.

## How do we compare internationally?

One of the justifications for the large increases in NHS spending planned for the next three years is that, compared with other countries, the UK spends a relatively low share of GDP on healthcare. Figure 3.1 shows that the UK's healthcare sector, at 6.7% of GDP, takes the smallest share of national income of all the G7 countries. The US is the biggest health spender among this group, with almost 14% of its GDP going to healthcare. Germany and France also have relatively large healthcare sectors: they take up 10.6% and 9.6% of their GDP respectively. Health spending in Japan and Italy is closer to that of the UK; both countries have a public sector of similar size but a larger private sector.

**Figure 3.1. Public and total health expenditure as a percentage of GDP in the G7 countries, 1998**




Source: *OECD Health Data 2000: A Comparative Analysis of 29 Countries*, CD-ROM.

It should be noted, however, that a lower share of GDP spent on health than in other countries should not necessarily be taken to imply a lower, or in some way less adequate, standard of healthcare. There are likely to be different costs of production and different levels of health – for example, due to exercise, diet and smoking patterns – between countries.[6] Despite being the second-lowest spender among G7 countries, Japan has the highest life expectancy for both

[6] For a discussion of all these issues, see, for example, O. Morgan, 'A cue for change: global comparisons in healthcare', Social Market Foundation, Discussion Paper no. 41, 1999.

men and women and the lowest level of infant mortality.[7] Levels of health spending could also vary due to different countries having different desired levels of healthcare.

Looking closer to home, within the EU, only Luxemburg (5.9%) and the Republic of Ireland (6.4%) have a smaller healthcare sector than the UK. Current government policy is that health spending should be increased towards the EU average. Across the European Union, average health spending in 1998 was 8.7% of GDP, with the average once the relatively low UK spending is excluded being 9.1% of GDP.[8] While the government's planned increases in NHS spending could increase health spending by 1.0% of GDP between 1998–99 and 2003–04, these increases alone will not be sufficient to close the gap between UK health spending and the EU average by March 2004. For example, assuming that the UK private sector and spending elsewhere in the EU remain constant as a share of national income, the gap between the UK and average spending in 2003–04 will still be equal to 1.3% of GDP, or £13.3bn in 2001–02 prices.

## 3.2 Spending on education

In contrast to the pledge made on the NHS, the 1997 Labour Party manifesto was more generous to education, stating that 'Education will be our number one priority, and we will increase the share of national income spent on education as we decrease it on the bills of social and economic failure'. Table 3.2 shows that, over the Conservatives' 18 years in office from 1979, education spending increased by an average 1.5% a year in real terms. Despite supposedly being the government's number one priority, education spending received an average real increase in spending of just 2.0% a year over the first two years of the Parliament, lower than the 2.9% average annual increase in GDP for the same period.

Along with health, education was the big winner from the July 1998 Comprehensive Spending Review.[9] Unlike health, the July 1998 education spending announcement implied a break from the past, since the Conservatives had been relatively less generous to education than they were to health. Again like health, the March 2000 Budget added additional resources to the supposedly fixed spending entitlements. As a result, spending over this Parliament is set to increase by 3.6% a year. Planned average increases in spending over the next three years from April 2001 to March 2004 are even

---

[7] C. Emmerson, C. Frayne and A. Goodman, *Pressures in UK Healthcare: Challenges for the NHS*, Commentary no. 81, IFS, London, 2000 (http://www.ifs.org.uk/health/nhsspending.pdf).

[8] Countries have been weighted by the size of their GDP. Currencies have been converted using 1998 exchange rates. An alternative methodology is to use purchasing power parities, but in practice this makes little difference. For a discussion of the weighted and the less meaningful unweighted averages, see L. Chennells, A. Dilnot and C. Emmerson (eds), *The IFS Green Budget: January 2000*, Commentary no. 80, IFS, London 2000 (http://www.ifs.org.uk/gbfiles/gb2000.shtml).

[9] HM Treasury, *Comprehensive Spending Review, July 1998*, HM Treasury, London, 1998 (http://www.hm-treasury.gov.uk/pub/html/csr/index.html).

higher, at 5.6% a year in real terms. This is slightly below the 5.7% a year real increase in spending planned for the NHS over the same period.

**Table 3.2. Real increases in education spending, various periods**

| | **Annualised average real increase (%)** |
|---|---|
| **Comparisons across Parliaments** | |
| This Parliament: *April 1997 to March 2001* | 3.6 |
| This Parliament: *April 1997 to March 2002* | 4.0 |
| Last Parliament: *April 1992 to March 1997* | 1.7 |
| Conservative years: *April 1979 to March 1997* | 1.5 |
| *of which:* | |
| John Major's period in office: *April 1991 to March 1997* | 2.1 |
| Margaret Thatcher's period in office: *April 1979 to March 1991* | 1.2 |
| **Other periods of interest** | |
| Current planned expenditure: *April 2001 to March 2004* | 5.6 |
| First two years of this Parliament: *April 1997 to March 1999* | 2.0 |
| Five-year increase from start of first CSR: *April 1999 to March 2004* | 5.4 |

Notes: UK education spending, excluding the sale of the student loan book in 1997–98 and 1998–99. For the periods in office of each political party and each Prime Minister, we assign financial years according to who was in office for the majority of months in that financial year. For example, Margaret Thatcher, who was Prime Minister from May 1979 to November 1990, is assumed to have determined public spending in the years from 1979–80 to 1990–91 inclusive.

Sources: HM Treasury, *Public Expenditure Statistical Analyses*, various years (most recent – http://www.hm-treasury.gov.uk/docs/2001/pesa_0304.html); HM Treasury, *Financial Statement and Budget Report*, various years (most recent – http://www.hm-treasury.gov.uk/budget2001/index.html). Spending figures deflated using the latest GDP deflators from the Office for National Statistics.

Since education spending has grown more quickly than growth in the economy (3.6% versus 2.9%), the government has met its manifesto commitment to increase spending as a share of GDP. This has increased from 4.7% in 1996–97 to 4.9% in 2000–01. Current forecasts suggest that the planned increases will see it continue to climb, to 5.3% in 2003–04. Average education spending over this Parliament will be 4.7% of GDP, which is actually lower than the 5.0% achieved by the Conservatives in the last Parliament. This is because education spending fell continuously as a share of GDP from 5.1% in 1992–93 to 4.5% in 1999–2000 and has only started increasing since April 2000. It is important to remember that, while spending as a share of GDP is a good measure of the government's priorities, the changes in economic growth should also be taken into account. Over the last Parliament, GDP grew by an annual average 2.6% compared with forecast growth of 2.9% over the first four years of this Parliament. This means that an increase in the share of GDP spent on education represents a higher real increase in such spending during this Parliament than during the previous one.

## 3.3 Other areas of government spending

Chapter 2 highlighted the fact that total public spending has grown less quickly under this Parliament than under either the previous Parliament or the Conservatives' entire period in office from 1979, while the NHS and education have received significantly greater increases in spending than in either of those two periods. This has been possible because combined spending on the NHS and on education only make up 27% of total public spending, and spending in other areas has grown less quickly.

### Social security spending

Social security spending, defined here to include items such as the working families' tax credit that have previously been considered to be social security benefits, has grown in real terms by an average of just 1.1% a year over this Parliament compared with 3.9% a year over the last Parliament, as shown in

**Table 3.3. Real increases in selected components of public spending over various periods**

| | Real average annual increase over: | | | | |
|---|---|---|---|---|---|
| | **Tories from 1979 to 1997** | **Last Parliament, April 1992 to March 1997** | **This Parliament to March 2001** | **This Parliament to March 2002** | **Labour's planned increase from April 2001 to March 2004** |
| Total spending | 1.7 | 2.0 | 1.4 | 1.9 | 3.7 |
| *of which:* | | | | | |
| Education | 1.5 | 1.7 | 3.6 | 4.0 | 5.6 |
| NHS | 3.1 | 2.6 | 4.8 | 5.1 | 5.7 |
| Social security | 3.6 | 3.9 | 1.1 | 1.7 | 2.2 |
| Defence | –0.2 | –3.0 | –1.3 | –1.2 | –0.2 |
| Transport | n/a | –2.9 | –1.4 | –0.0 | 11.5 |
| Debt interest | n/a | 8.5 | –3.6 | –6.1 | –5.7 |
| Memo: GDP growth | 2.1 | 2.6 | 2.9 | 2.8 | 2.5 |

Notes: Includes spending financed by the windfall tax. Hence figures given for growth in total spending over the current Parliament and under Labour's plans are slightly higher than those shown in Table 2.1, which excluded the windfall tax and associated spending. UK education spending excludes the sale of the student loan book in 1997–98 and 1998–99. UK NHS spending is net of NHS charges and receipts. Social security spending includes benefit expenditure administered by the DSS, administration costs of running the DSS plus expenditure on the working families' tax credit and the disabled person's tax credit in order to ensure consistency over time. Spending on defence excludes revenues from the sale of married quarters in 1996–97 and 1997–98. Debt interest is central government interest payments only.

Sources: Department of Health, *The Government's Expenditure Plans*, various years (most recent – http://www.doh.gov.uk/dohreport/report2000/dr2000.html); Office of Health Economics, *Compendium of Health Statistics*, various years; Department of the Environment, Transport and the Regions, *Transport 2010: The 10 Year Plan*, DETR, London, 2000 (http://www.detr.gov.uk/trans2010/index.htm); HM Treasury, *Public Expenditure Statistical Analyses*, various years (most recent – http://www.hm-treasury.gov.uk/docs/2001/pesa_0304.html); HM Treasury, *Financial Statement and Budget Report*, various years (most recent – http://www.hm-treasury.gov.uk/budget2001/index.html). Spending figures deflated using the latest GDP deflators from the Office for National Statistics.

Table 3.3. This is particularly important since spending on social security is the biggest single element of public expenditure, comprising 30% of all government spending. As in spending on health and education, there is an interesting contrast between the first two years of the Parliament and the subsequent years. Between April 1997 and March 1999, social security spending fell by an average 1.0% a year, while in the following two years, from April 1999 to March 2001, it is forecast to rise by an average of 3.3% a year. While this is partly explained by the fact that unemployment fell by more in the first two years of this Parliament than it did in years three and four, it is also true that many of the increases in social security benefits, such as the working families' tax credit, income support for those with children, the basic state pension and the minimum income guarantee for pensioners, have come in the second half of this Parliament.

Going forward, the government's forecasts for social security spending imply an average 2.2% a year real increase in spending over the next three years. It is important to note that these are based on current policies. Hence the cost of measures that the government is currently consulting on, and, if re-elected, seems likely to implement, is not included in the current plans. These measures include the integrated child credit, the employment tax credit and the pension credit.[10]

## Spending by other departments

Table 3.3 also shows that the current government has benefited from reductions in debt interest spending averaging 3.6% a year between April 1997 and March 2001. This compares with an 8.5% average annual real increase in spending on debt interest over the last Parliament. This reduction in debt interest is a result both of the increases in taxes and reductions in overall public spending described in Chapter 2 leading to a lower stock of debt and of low interest rates reducing the interest payments for any given amount of debt.

The current government has also cut defence spending, by 1.3% a year on average. This compares with larger average cuts of 3.0% a year over the last Conservative Parliament, but is greater than the 0.2% average annual cut seen over the Conservatives' period in office from 1979 to 1997. Government plans imply that this cut will be matched going forward, with defence spending being cut by an average of 0.2% per year over the next three years.

Transport spending has been cut by an annual average of 1.4% a year over the first four years of this Parliament, which is due to a combination of tight planned expenditure in 1997–98 and 1998–99 and of a significant DETR underspend in 1999–2000. Over the five-year Parliament to March 2002, there

---

[10] For details of the integrated child credit, see M. Brewer, M. Myck and H. Reed, *Financial Support for Families with Children: Options for the New Integrated Child Credit*, Commentary no. 82, IFS, London, 2001 (http://www.ifs.org.uk/taxben/icc.shtml). For details of the employment tax credit, see A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2001*, Commentary no. 83, IFS, London, 2001, (http://www.ifs.org.uk/gbfiles/gb2001.shtml). For details of the pension credit, see T. Clark, *Recent Pensions Policy and the Pension Credit*, IFS Briefing Note no. 17, 2001 (http://www.ifs.org.uk/pensions/bn17.pdf).

is no forecast increase in transport spending. This compares with a cut in spending averaging 2.9% over the previous Conservative Parliament. Over the next three years, there is a substantial planned increase in transport spending, averaging 11.5% a year in real terms. Even if these planned increases are delivered by 2003–04, transport spending will still be lower in real terms than it was in 1994–95.

## Public investment spending

Both the July 1998 Comprehensive Spending Review and the July 2000 Spending Review announced that there was to be a substantial increase in capital spending. In fact, as shown in Table 3.4, as yet this has failed to materialise. Over this Parliament, there have been reductions in real investment spending averaging 4.4% a year, implying a total decline of 16.4% over the four-year period. Even in cash terms, investment spending in 2000–01 was £4.3bn, which is less than the £4.7bn achieved in 1996–97, the last year of the previous Parliament.

**Table 3.4. Real increases in net public sector investment spending over various periods**

| | **Annualised average real increase (%)** |
|---|---|
| **Comparisons across Parliaments** | |
| This Parliament: *April 1997 to March 2001* | –4.4 |
| This Parliament: *April 1997 to March 2002* | 15.8 |
| Last Parliament: *April 1992 to March 1997* | –16.6 |
| Conservative years: *April 1979 to March 1997* | –5.3 |
| *of which:* | |
| John Major's period in office: *April 1991 to March 1997* | –9.9 |
| Margaret Thatcher's period in office: *April 1979 to March 1991* | –3.0 |
| **Other periods of interest** | |
| Current planned expenditure: *April 2001 to March 2004* | 60.1 |
| First two years of this Parliament: *April 1997 to March 1999* | –9.5 |
| Last two years of this Parliament: *April 1999 to March 2001* | 1.0 |

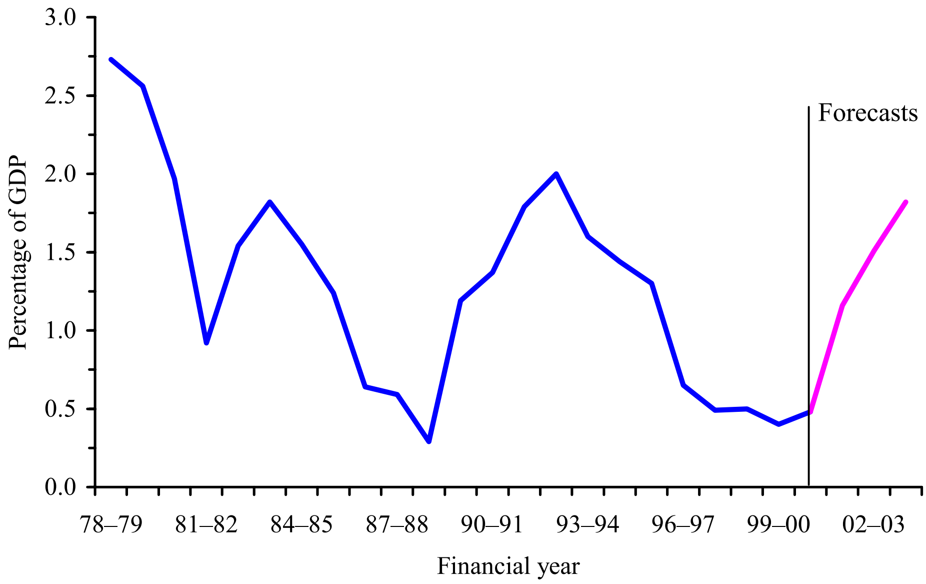
Notes: For the periods in office of each political party and each Prime Minister, we assign financial years according to who was in office for the majority of months in that financial year. For example, Margaret Thatcher, who was Prime Minister from May 1979 to November 1990, is assumed to have determined public spending in the years from 1979–80 to 1990–91 inclusive.

Sources: HM Treasury, *Financial Statement and Budget Report*, various years (most recent – http://www.hm-treasury.gov.uk/budget2001/index.html); ONS / HM Treasury Press Release, *Public Sector Finances: March 2001*, 23 April 2001 (http://www.statistics.gov.uk/pdfdir/psf0401.pdf). Spending figures deflated using the latest GDP deflators from the Office for National Statistics.

These overall reductions in investment spending reflect cuts in the first two years of this Parliament averaging 9.5% a year, followed by two years in which spending has only increased by an average 1.0% a year despite significant planned increases. Government departments – in particular, the Department for Education and Employment and the Department for the Environment, Transport and the Regions – failed to spend up to their entitlements in 1999–2000.[11] The latest aggregate figures for net investment spending in 2000–01 show that considerable underspending occurred in that year too.[12] This underspend is significant, even when compared with the March 2001 Budget projection, made just four weeks before the end of the financial year, which forecast investment spending of £7.4bn in 2000–01. The latest figures suggest that the out-turn was £4.3bn.

The reductions in public sector net investment, and the failure of government departments to deliver the planned increases in public spending, are perhaps even more surprising when it is noted that they follow the last Parliament, in which there were real cuts in net investment spending averaging 16.6% a year. In fact, throughout the Conservatives' period in office, increases in current spending were partially sustained through cuts in the real capital budget averaging 5.3% a year.

**Figure 3.2. Public sector net investment as a percentage of GDP, 1978–79 to 2003–04**




Source: HM Treasury, *Financial Statement and Budget Report, March 2001*, Hc279, The Stationery Office, London, 2001 (http://www.hm-treasury.gov.uk/budget2001/index.html).

Public sector net investment as a share of GDP over time is shown in Figure 3.2. It has fluctuated substantially over the last 20 years – for example, increasing from 0.3% of GDP in 1988–89 to 2.0% in 1992–93 before falling back to 0.6% of GDP in 1996–97. The current government identified these cuts in investment as one of the key 'problems with previous approaches to

[11] For more details, see A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2001*, Commentary no. 83, IFS, London, 2001 (http://www.ifs.org.uk/gbfiles/gb2001.shtml).

[12] Unfortunately, no breakdown of this latest figure for net investment spending by government departments is available yet.

public spending' from which, it argued, lessons had to be learned.[13] Despite this, over the last four years, the current government spent an average of less than ½% of GDP per year on public sector net investment – easily the lowest figure for any four-year period since the Second World War. The average over the last two years of the Parliament, which were covered by the first Comprehensive Spending Review, is actually lower than the average over the first two years of the Parliament. Why so much of the planned investment has failed to materialise – or, at least, to show up in the official statistics – has yet to be satisfactorily explained.

The plans for the next three years are for real increases averaging 60.1% a year. If delivered, these would clearly be rapid increases in spending – although from a base that is very low by historical standards, due to cuts in public investment spending since 1992–93.

Offsetting the cuts in traditional public investment, shown in Figure 3.2, there has been considerable growth in privately delivered but publicly sponsored investment spending under the Private Finance Initiative (PFI). This now represents 0.4% of GDP.[14]

Looking forward, total publicly sponsored investment by 2003–04 should be comparable to the levels seen at the beginning of the 1990s. This depends, first, on the current planned large increases in public spending actually being delivered, and, second, on PFI spending being included alongside traditionally financed projects. Even if these assumptions are granted, whether these planned levels of investment represent a significant break depends on the new investment being sustained, not cut back, as was the case after previous years of high public investment, notably 1983–84 and 1992–93.

*Carl Emmerson and Christine Frayne*

---

[13] HM Treasury, *Planning Sustainable Public Spending: Lessons from Previous Policy Experience*, November 2000 (http://www.hm-treasury.gov.uk/pdf/2000/spending_lessons0311.pdf).

[14] Source: HM Treasury, *Financial Statement and Budget Report, March 2001*, Hc279, The Stationery Office, London, 2001 (http://www.hm-treasury.gov.uk/budget2001/index.html).

# 4. Living standards under Labour

The four years of the New Labour government have seen a rise in living standards across the income distribution. This has been a period of consistent economic growth, during which time average earnings have risen, employment has grown and the generosity of many benefits, for those in and out of work, has risen. Despite the tax increases described in Chapter 2, net incomes are higher now on average than they were four years ago.

The gains in living standards over this Parliament have been unevenly spread across the income distribution – income inequality was higher in 1999–2000 than it was before Labour came to power. But in the final year for which we have data (1999–2000), inequality seems to have stopped rising. Despite the overall increase in inequality, the numbers in poverty, as measured both by absolute and by some relative measures, fell in the two years to 1998–99, although the changes in poverty occurring after this time are not yet known.

This chapter examines the changes in living standards, inequality and poverty that have taken place under the Labour government, putting them in the context of the changes over the last two decades.

## 4.1 What has happened to average incomes?

A good starting-point for understanding the changes in living standards that have occurred is official statistics on real disposable household income per head from the National Accounts. These are published quarterly and are available up to the end of 2000. They show how the level of household incomes per head, net of income tax and National Insurance contributions, has changed in recent years. Changes in this series are shown in Table 4.1. Living standards have risen on average during this Parliament: real disposable income per head was approximately 9% higher in 2000 than it was when Blair first came to office. The average rate of growth each year implied by this, at 2.3%, is the same as the average annual growth rate during the entire period of Conservative government from 1979, although it is somewhat lower than that seen during the Thatcher years and higher than that seen while Major was Prime Minister.

**Table 4.1. Changing real disposable household income per head (%)**

| | Overall growth | Average annual growth National Accounts |
|---|---|---|
| Conservative years | 50.4 | 2.3 |
| Thatcher years | 33.0 | 2.6 |
| Major years | 13.0 | 2.0 |
| Blair to December 2000 | 9.0 | 2.3 |

Source: IFS calculations based on *Economic Trends* (various years) and Office for National Statistics, Press Release, ‘Quarterly National Accounts 4th Quarter and Year 2000’, 26 March 2001.

Given that this government's period of office has seen consistent economic growth, it may seem surprising that the average growth in living standards over this time has been no higher than for the previous twenty years. One reason is that the disposable income measure used here better captures some of the increases in the tax burden in recent years than other commonly used measures. This is because income is measured net of *all* income tax, including the negative income tax implied by the income tax credits on pension funds' dividend income, which were abolished by this government in 1997. The abolition of these credits is equivalent to an income tax rise, since although its incidence is not on households directly, it does hit the pension funds that they hold. The abolition of these credits will have had the effect of reducing net incomes by an estimated £5bn paid out of total household income, which is now £620bn.[1]

As data from the first quarter of 2001 remain unavailable, the figures for this Parliament are incomplete. As well as growth in average earnings, and falls in unemployment over the early part of the year, a number of tax and benefit changes in April 2001 should help increase incomes further. These include increases in the basic state pension, higher means-tested benefits for families with children and income tax cuts delivered through the children's tax credit and the wider 10p band announced in the March 2001 Budget. There are also tax increases in April that will partly offset these rises in households' incomes, such as an increase in National Insurance contributions.

## 4.2 What has happened to the gap between rich and poor?

Before he became Prime Minister, Tony Blair stated 'if the next Labour government has not raised the living standards of the poorest by the end of its time in office, it will have failed'.[2] Our analysis shows that the living standards of the poorest have indeed risen under this government, although the gains experienced at the bottom of the income distribution in the first three years of the Parliament have been smaller than the growth in living standards experienced by those higher up the income scale.

In order to analyse the income changes across the distribution, we need to use information obtained from detailed household surveys, rather than the aggregate National Accounts data cited above. Although such data are published annually by the Department of Social Security in its Households Below Average Income (HBAI) series, these official statistics are currently only available for the first two years of the Parliament, up to 1998–99.[3] Using detailed information from the Family Expenditure Survey, we have been able to extend this analysis for a further year, in order to assess how living

[1] Sources: HM Treasury, *Financial Statement and Budget Report*, Hc85, The Stationery Office, London, 1997; Office for National Statistics, Press Release, 'Quarterly National Accounts 4th Quarter and Year 2000', 26 March 2001, Table J2.

[2] Interview in the *Independent on Sunday*, 26 July 1996.

[3] Data for 1999–2000 will be published by the DSS in the summer.

standards have changed for different groups up to April 2000.[4] The analysis is based on net weekly household income adjusted to take account of family size and measured before housing costs have been paid.

It should be noted that the HBAI series differs from the National Accounts data in certain important respects. First, it is likely to be less accurate because it is based entirely on interviews of samples of the population, and so is more subject to sampling and measurement error. The income definition also differs between the two series. For example, the HBAI series is measured net of council tax (and its local tax predecessors), whereas the National Accounts data are not; the National Accounts data are affected by changes such as the abolition of pension fund income tax credits (discussed in Section 4.1), whereas such changes are not captured by HBAI. These and other definitional differences mean that the average changes in living standards over different periods do not coincide exactly, although they do show a similar trend.[5]

In order to assess how the changes in living standards differ across the income distribution, the population has been divided into five equal-sized groups of the population ranked according to income, known as quintile groups. Box 4.1 shows the income levels at which different families fit into these quintile groups, expressed in January 2001 prices.

**Box 4.1. Where do you fit in? Weekly net incomes of three family types, by quintile, January 2001 prices**

| | Single person, no children | Couple, no children | Couple with two children (aged 4 and 13) |
|---|---|---|---|
| Bottom quintile | £0 to £107 | £0 to £176 | £0 to £255 |
| 2nd quintile | £108 to £148 | £177 to £243 | £256 to £353 |
| 3rd quintile | £149 to £200 | £244 to £328 | £354 to £475 |
| 4th quintile | £201 to £278 | £329 to £455 | £476 to £660 |
| Top quintile | £279+ | £456+ | £661+ |

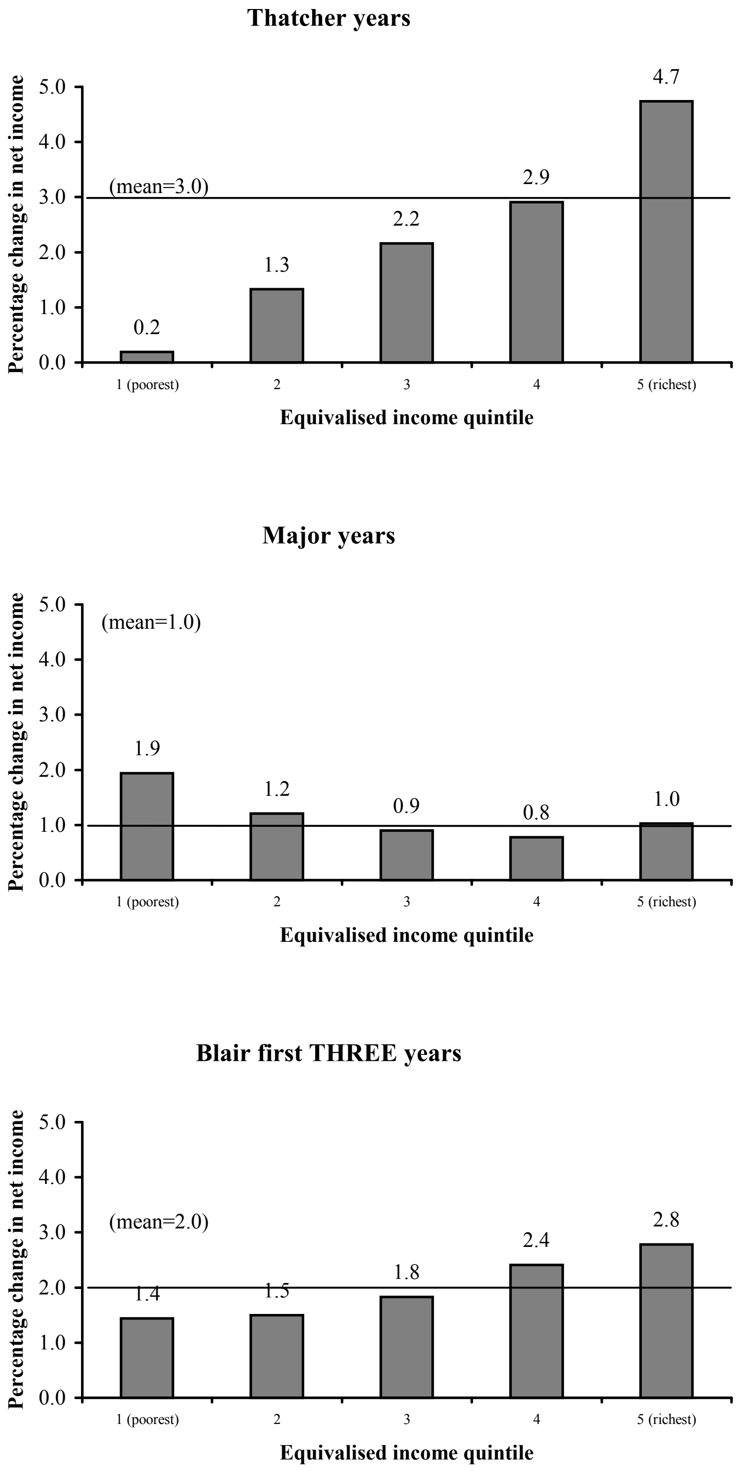
Source: Family Resources Survey, 1998–99.

How have the living standards of these income groups changed over time? Figure 4.1 shows changes in living standards across the income distribution over different periods. During the Thatcher years (1979–90), income growth was highly unequal, with incomes growing most slowly in the bottom quintile, and more quickly in each subsequent quintile group. The real incomes of the bottom fifth barely rose at all in real terms each year, compared with real growth averaging 4.7% per year amongst the top fifth of the population.

[4] The series has also been extended backwards in time and is available from IFS covering every year back to 1961.

[5] In particular, the HBAI series shows a substantially lower growth in average living standards under Major than is shown in the National Accounts.

**Figure 4.1. Income growth for rich and poor under different Prime Ministers (real annual average growth)**



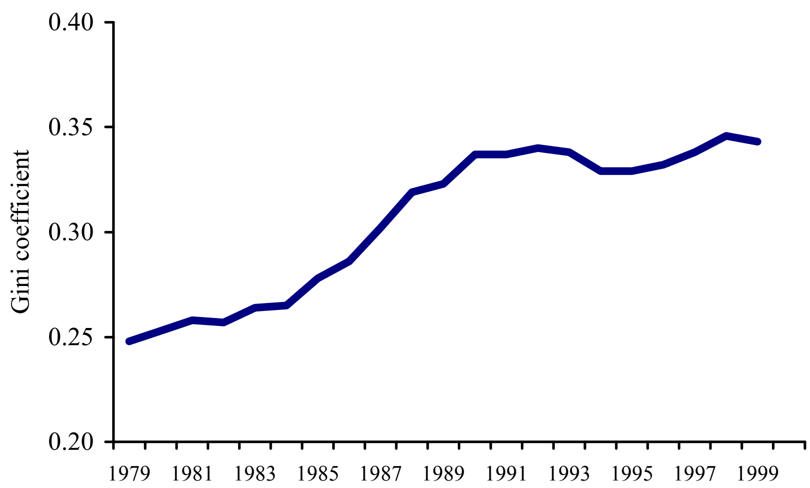

Note: The income measure used is net household weekly equivalent before-housing-costs income. This is the same measure as used by the DSS in its Households Below Average Income series.
Source: IFS calculations based on Family Expenditure Survey and Family Resources Survey.

During this time, it was those in work, particularly those higher up the income scale, who saw the largest rises in their living standards. People on low earnings and those in households with no earners – for example, many lone-parent families – saw their incomes stagnate in real terms.[6]

By comparison, the Major years (1990–97) saw considerably lower average income growth across the whole population, reflecting the recession of the early 1990s. But the income gains that there were over this period were disproportionately enjoyed by families at the lower end of the income distribution.

The pattern of changes in living standards over the first three years of the Blair government shows income growth that, as in the Thatcher years, is skewed towards the middle and upper parts of the income distribution, although it is clear from Figure 4.1 that these changes are not as unequal as those that took place during the 1980s. The mean income of the poorest fifth grew at an average annual rate of 1.4% over the three years to April 2000, with a similar rate of growth also shown in quintiles 2 and 3. The growth in the fourth quintile was equivalent to a 2.4% real-terms increase per year, with a 2.8% rise amongst the richest fifth.

**Figure 4.2. The path of inequality: the Gini coefficient, 1979–1999/2000**




Note: The income measure used is net household weekly equivalent before-housing-costs income. This is the same measure as used by the DSS in its Households Below Average Income series.
Source: IFS calculations based on Family Expenditure Survey and Family Resources Survey.

These changes in incomes across the distribution mean that income inequality rose over the first three years of this government. The most commonly used measure of income dispersion – the Gini coefficient – is mapped out in Figure 4.2, which shows that inequality grew over the first two years of this Parliament, before falling back slightly in the year ending in April 2000.

[6] Of course, there is some mobility in the income distribution, so when analysing income differentials across the distribution over several years, it must be recalled that each quintile contains different individuals in each period. Similarly, in income analysis by family type, it is clear that the type of family an individual is classed as belonging to will vary over time.

While such a small drop could certainly reflect nothing more than statistical sampling variation, the fact that inequality did not move upwards, as it has done in recent years, could also reflect both the effects of falling unemployment and the first results of increasing benefits for the poor. Despite this small fall in inequality in the final year, it remains the case that measured inequality was higher in 1999–2000 than before Labour came to power.

This compares with the strongly rising income inequality over the 1980s, which was followed by a modest decline in measured income inequality over the early 1990s as the wages of the best-off were temporarily restrained by recession. Economic growth in the middle part of the decade coincided with a new upturn in income inequality.

# 4.3 What has happened to poverty?

Although the government has not made a reduction in income inequality one of its explicit aims, in the last two years it has been explicit in its goals towards poverty, in particular in its ambition to eradicate child poverty in 20 years and halve it in 10 years. In his speech to Labour's Spring Conference this year, Gordon Brown hinted that a similar goal towards pensioner poverty might be in the pipeline, stating: 'Let us be the generation that abolished child and pensioner poverty'.[7]

The government has been keen to emphasise that low incomes are just one aspect of poverty, with 31 different indicators of poverty set out in its annual audit of poverty, *Opportunity for All*.[8] However, relative and absolute income poverty lines remain central. As with inequality, published data are only available for the first two years of the Parliament. These show modest falls in the number of non-pensioners and children below the government's headline measure (60% of median after-housing-costs income) but a small increase in the number of pensioners below this same line.

These results are shown in Table 4.2. The number of people in households whose income falls below 60% of median after-housing-costs (AHC) income fell slightly over the first two years of the Parliament, from approximately 24.6% of the population to 23.7% of the population, a drop of around half a million people. The number of children living below this poverty line also fell very slightly over the two years to April 1999, by about 150,000, but remained at more than 4m children, or approximately one in every three. By contrast, the number of pensioners below the line rose slightly, by about 40,000 over the two years in question.

These small falls in relative poverty are not robust to the choice of poverty line. Although the numbers below various fractions of median income, measured both before and after housing costs, have fallen, the number of

[7] Gordon Brown, Labour Party Spring Conference in Glasgow, 16 February 2001.

[8] Department of Social Security, *Opportunity for All – One Year On: Making a Difference. Second Annual Report 2000.* Cm. 4865, The Stationery Office, London, 2000.

**Table 4.2. Number of people with incomes below 60% median after-housing-costs income**

| | Below 60% contemporary median | | | Below 60% 1996–97 median | | |
|---|---|---|---|---|---|---|
| | 1996–97 | 1997–98 | 1998–99 | 1996–97 | 1997–98 | 1998–99 |
| Total people | | | | | | |
| Number (m) | 13.9 | 13.6 | 13.4 | 13.9 | 13.3 | 12.6 |
| Proportion | 0.246 | 0.241 | 0.237 | 0.246 | 0.235 | 0.223 |
| *of whom:* | | | | | | |
| Children | | | | | | |
| Number (m) | 4.4 | 4.3 | 4.3 | 4.4 | 4.2 | 4.0 |
| Proportion | 0.340 | 0.334 | 0.332 | 0.340 | 0.328 | 0.315 |
| Pensioners | | | | | | |
| Number (m) | 2.2 | 2.3 | 2.3 | 2.2 | 2.2 | 2.0 |
| Proportion | 0.266 | 0.271 | 0.271 | 0.266 | 0.260 | 0.241 |

Source: IFS calculations based on Family Resources Survey. These are the same as those to be found in Department of Social Security, *Households Below Average Income 1994/5 to 1998/9*, Corporate Document Services, Leeds, 2000.

people below 50% of the mean, which is influenced more strongly by income changes at the top of the income distribution, in fact rose slightly over the first two years of the Parliament.

Because of the consistent income growth across the distribution – discussed in the previous section – the numbers falling below absolute levels of income have fallen more decisively. For example, the number of people living below £140 per week for a childless couple (60% of the median AHC income in 1996–97, uprated to 2001 prices) fell by about 1.2m in the first two years of the Parliament, from 13.9m (as shown in Table 4.2) to approximately 12.6m. Of this fall, 400,000 were children and 200,000 were pensioners.

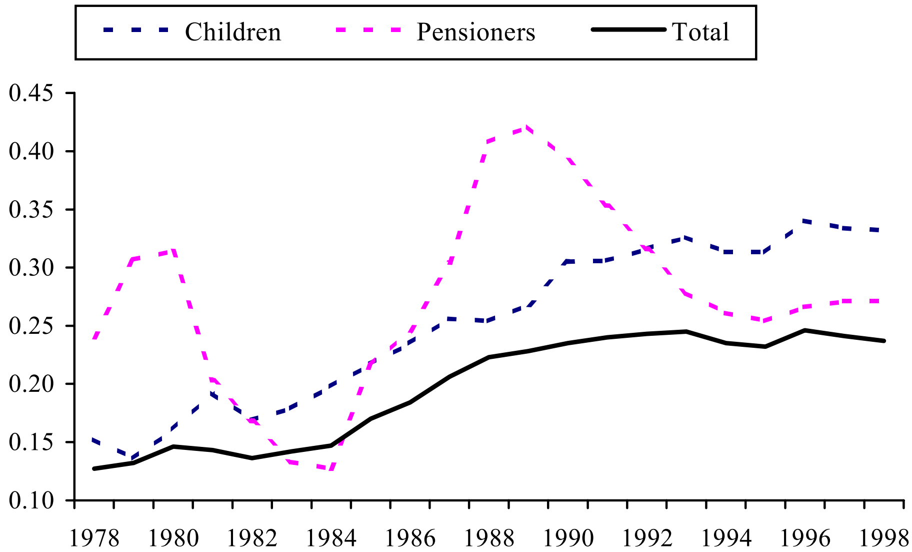
If data were available for the full four years of the Parliament, it is likely that more unequivocal falls in both absolute and relative income poverty would be shown. It has been estimated that, other things being equal, reforms to the tax and benefit system over the first four Budgets of this Parliament will lift approximately 1.2m children out of poverty, with most of the measures effecting this reduction coming in the 1999 and 2000 Budgets.[9] Increases in employment in the second half of the Parliament should also have resulted in a reduction in the number of working-age families below the poverty line. The number of pensioners in relative poverty is also likely to have fallen over the last two years, with significant increases in the pensioner minimum income guarantee and increases in other pensioner benefits, such as the winter fuel allowance, coming into effect during this time.

However, these benefit increases will not be sufficient to bring levels down to anywhere near the levels of relative poverty that were prevalent before the

[9] See: HM Treasury, *Financial Statement and Budget Report, March 2001*, Hc279, The Stationery Office, London, 2001 (http://www.hm-treasury.gov.uk/budget2001/index.html); H. Sutherland and D. Piachaud (2001), 'Reducing child poverty in Britain: an assessment of government policy 1997-2001', *Economic Journal*, vol. 111, no. 469, F85–F101, February 2001.

1980s. This can be seen in Figure 4.3, which places the changes in relative poverty over the first two years of this Parliament in context. The graph shows the proportion of all people, pensioners and children whose household income fell below 60% of the contemporary median AHC income, for each year from 1978 to 1998–99. The total number of people falling below this poverty line rose rapidly over much of the 1980s, from approximately one in eight in 1979 to close to one in four at its peak in the early 1990s. Over the 1990s, the total number of people in poverty on this measure has fluctuated, but, as shown in Table 4.2, it has been falling since 1996–97.

**Figure 4.3. Proportion of children, pensioners and all people with incomes below 60% median after-housing-costs income**




Source: IFS calculations based on Family Expenditure Survey and Family Resources Survey.

The proportion of pensioners and children in poverty on this measure is higher than that of the population at large, since these families are heavily represented at the lower end of the income distribution. As Figure 4.3 shows, the proportion of children in relative poverty more than doubled over the 1980s, from about 15% to more than 30% in the early 1990s, and it peaked at 34% in 1996–97.

The number of pensioners in poverty on this measure has fluctuated quite dramatically over the entire period, with a strong cyclical pattern. During economic booms, relative pensioner poverty has risen, whilst during slowdowns and recessions, pensioner poverty has fallen. These large fluctuations arise for two reasons. First, pensioner benefits have tended to rise less quickly than earnings. This means that, during periods of high earnings growth, the number of pensioners below relative poverty lines has grown quickly; during economic slowdowns, the number has gone down. Second, the size of the fluctuations is mostly due to the heavy concentration of pensioners around the poverty line, meaning that small changes in the poverty line shift large numbers of pensioners into or out of measured poverty. This highlights one of the major drawbacks of using arbitrary poverty lines such as this one. A useful alternative is to look at direct measures of deprivation that accompanies low income.[10] Such movements also suggest that the increases in pensioner benefits that have been announced but are yet to be brought into effect are likely to reduce the number of pensioners in poverty on this measure quite considerably.

It is interesting to note that, having peaked at 42% in 1989–90 and fallen over the first part of the 1990s, the number of pensioners in poverty on this measure did not rise nearly as rapidly over the recent period of economic growth as it did over the 1980s. This reflects the fact that both the last government and this one have raised the level of means-tested pensioner benefits by more than inflation. Price-indexation schemes in many private pension schemes also mean that many pensioners benefited from the onset of low inflation in the early 1990s.

## 4.4 Conclusions

The extent to which the government is responsible for these changes in living standards and poverty is open to debate. Typically, governments tend to take credit for improvements when incomes are growing, but blame factors outside their control when incomes are falling. The impact of government tax and benefit measures, discussed in Chapter 5, provides a clearer indicator of government's direct impact on living standards.

Does the small measured fall in inequality seen in 1999–2000 represent the start of a sustained reduction? It remains too early to tell. Budget measures recently implemented and in the pipeline are likely to compress inequality somewhat, if all else is equal. But beyond this, predicting the path of income inequality is difficult and depends on what policies the new government chooses to implement. If the Labour government secures a second term, further redistribution through tax and social security policies is likely if the government pursues its stated aim of eradicating child poverty. In addition, the government's aspiration of increasing means-tested benefits for pensioners with earnings each year (rather than in line with prices, which has been the norm for the last twenty years) should mean that the incomes of the poorest pensioners will not fall further behind those of the rest of society as the economy grows. But perhaps the most important determinants of income inequality are found in the labour market, and changes here are much harder to predict and, indeed, harder for any government to control.

Whether or not income inequality will fall significantly remains to be seen. Whatever changes do take place, one thing is clear, however: even if inequality does fall, it is unlikely to return soon to the levels seen before the dramatic changes of the last twenty years.

*Tom Clark and Alissa Goodman*

[10] See, for example, D. Gordon et al., *Poverty and Social Exclusion in Britain*, Joseph Rowntree Foundation, York, 2000.

# 5. 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 chapter reviews these, before assessing how their effect has varied between different groups of the population. Chapter 4 examined changes to overall living standards, which largely reflect things outside government control, but this chapter looks at the effect of tax and benefit policy in isolation. Another difference from Chapter 4 is that we are able to assess Labour's full term here.

## 5.1 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 5.4.

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 chapter will overstate the eventual average gain to households resulting from government policy. Table 5.1 shows the budgetary effects of the modelled changes.

**Table 5.1. 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 5.3 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.

# 5.2 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 Chapter 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 5.2. 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.

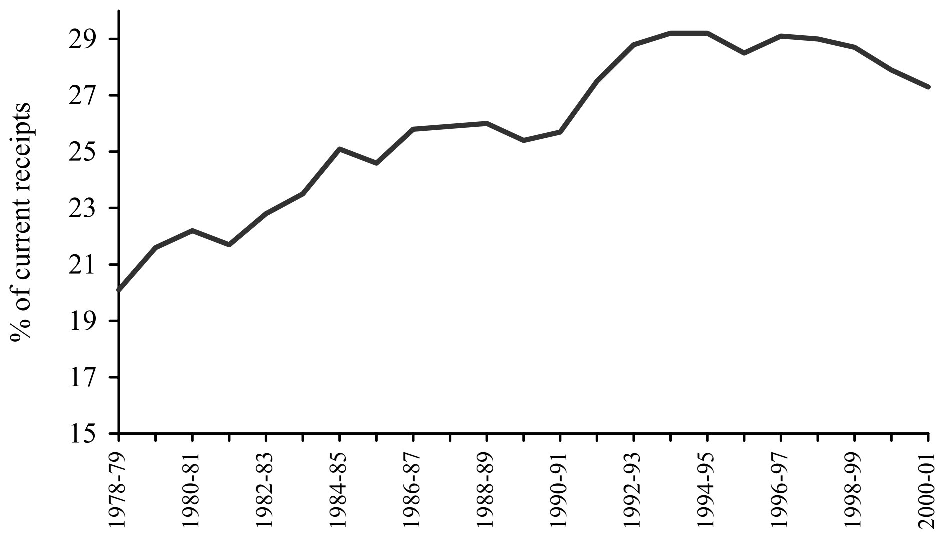
Table 5.2 charts the most important changes and explains who gained and lost from them and by how much.

## 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 5.1 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 5.1. 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 5.3 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 5.3. 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.

# 5.3 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 5.4 shows that, while 36 million adults have seen gains in household post-tax income, almost 8 million have lost from the reforms.

**Table 5.4. 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 5.2 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)

---

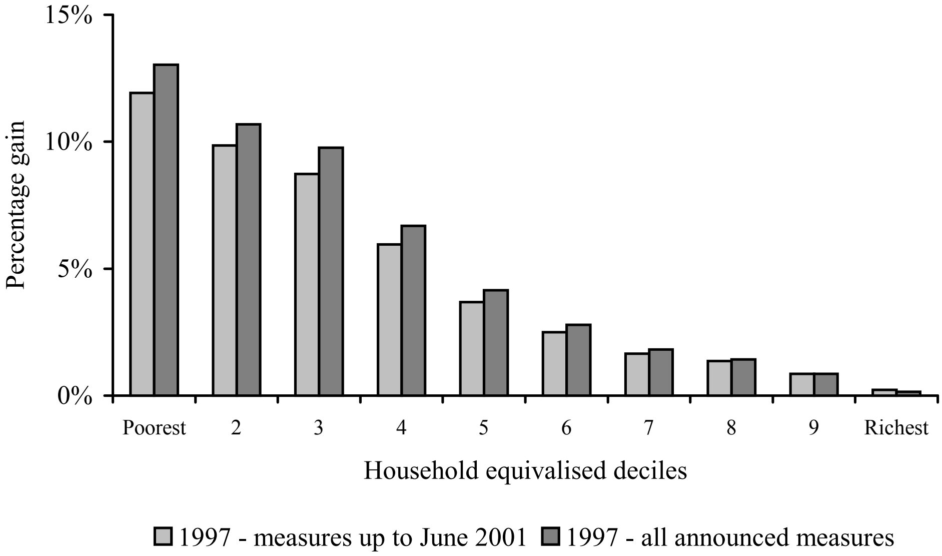
[2] *Transport Statistics Great Britain 1999 Edition*, The Stationery Office, London, 1999.

[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 5.2. 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 5.2 (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 5.3 illustrates this, showing the *fraction* of families in different parts of the income distribution that have gained or lost by different amounts.

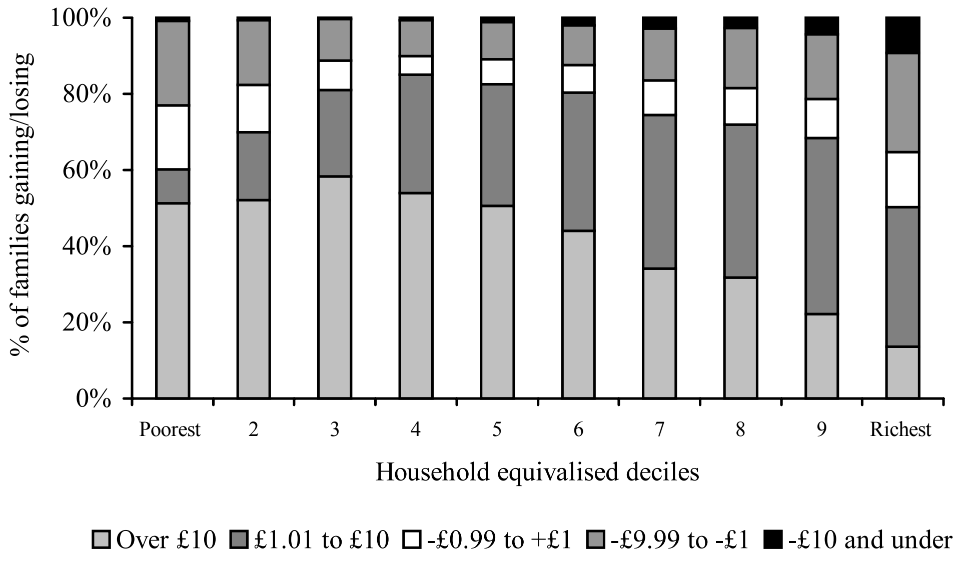
The progressive nature of the measures remains clear. Over 50% of households in the bottom half of the income distribution have seen their net income rise by more than £10 per week; in contrast, fewer than 14% of the top decile experienced the same. Some 9% of households in the richest 10% of the population 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.

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

[6] Chapter 11 discusses the extension of means testing more fully.

**Figure 5.3. 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 5.5, 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 5.5. 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.

# 5.4 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 5.6. 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 5.6. 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.

# 5.5 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.

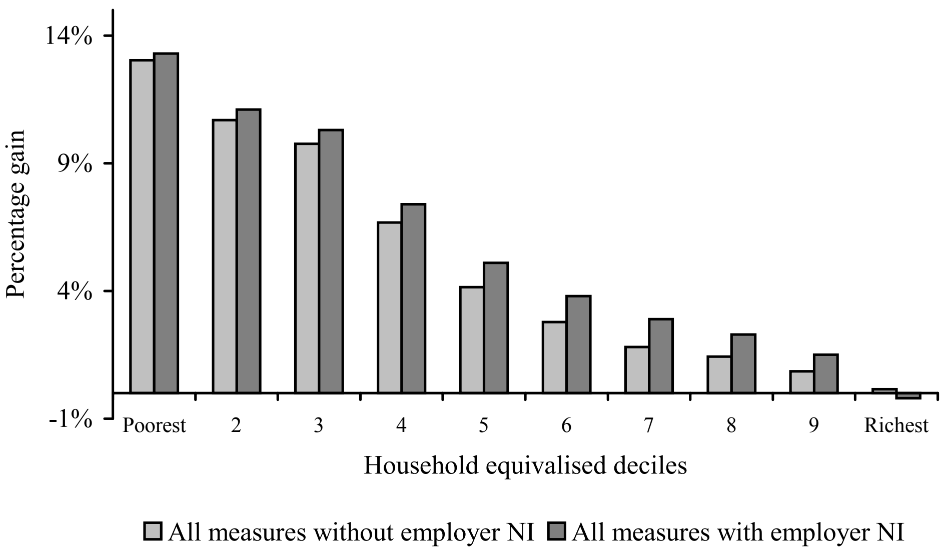
[11] Source: *Inland Revenue Statistics*, 2000.

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 5.4 repeats the numbers from Figure 5.2 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 5.4. 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%.

## 5.6 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.

*Tom Clark, Michal Myck and Zoë Smith*

# 6. Labour and business taxes

Since winning the 1997 election, Labour has made a number of changes to business taxes. The first part of this chapter will deal with general measures. This is followed by a discussion of measures aimed at smaller firms. Finally, the windfall levy and the climate change levy will be discussed. Box 6.1 lists the main changes that have occurred.

**Box 6.1. Main changes to taxes paid by companies and shareholders since 1997**

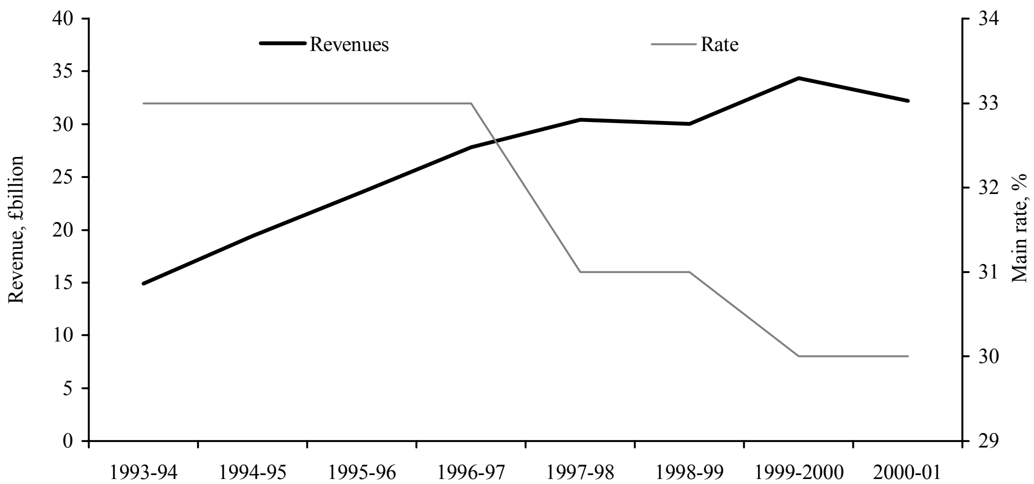
- Main corporation tax rate cut from 33% to 30%
- Dividend tax credits no longer repayable to tax-exempt shareholders
- Abolition of advance corporation tax (ACT)
- Introduction of quarterly corporation tax payments for large firms
- One-off ‘windfall’ tax on privatised utilities
- Introduction of climate change levy

## 6.1 Taxes on corporate profits

### Corporation tax

Since 1997 the headline corporation tax rate has been reduced by three percentage points, but government revenues from corporation tax have continued to rise, as shown in Figure 6.1.

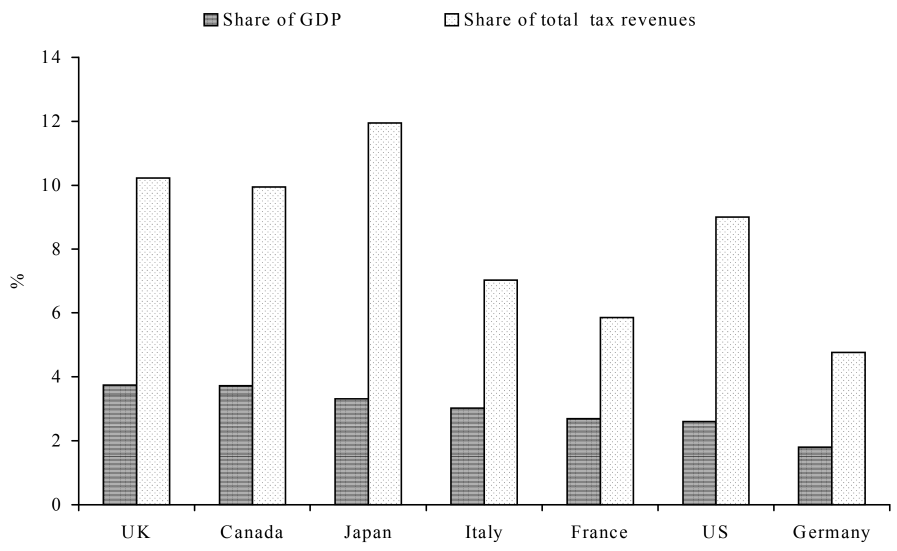
**Figure 6.1. Corporation tax: revenues and headline rate**




Source: Inland Revenue Statistics, 2000.

Corporate tax rates have fallen over the last decade in many OECD countries. In the UK, this trend dates back to Lord Lawson's 1984 reform, which cut the main corporation tax rate from 52% to 35%. The UK's current 30% main rate is one of the lowest in the OECD. The tax rate, however, is only one determinant of the tax bills that companies face: these also depend on the generosity of deductions, most notably capital allowances for depreciation. Figure 6.2 compares revenues from tax on corporate income, both as a share of GDP and as a proportion of total tax revenue, across the G7 countries. Despite the UK's low corporation tax rate, corporate tax revenues are actually high compared with other G7 countries. In fact, according to the latest OECD figures, the UK takes a higher fraction of GDP in corporate taxes than any other G7 country.[1]

**Figure 6.2. Taxes on income, profits and capital gains paid by corporations**




Notes: Figures are for 1999, except for US and Canada, where 1998 figures are shown. Figures show all taxes on income, profits and capital gains paid by corporations, and so include petroleum revenue tax (PRT) in the UK. In 1999, PRT was just 0.05% of GDP and 0.15% of total tax revenue, so its inclusion does not substantially alter the overall picture. Figures also include revenues from local corporate income taxes, which apply in all G7 countries except France and the UK.
Source: OECD Revenue Statistics, 2000.

Figure 6.1 showed that total corporation tax receipts have increased by £4.4bn, from £27.8bn in 1996–97 to £32.2bn in 2000–01, a 16% cash increase. This may seem surprising, given that the three-point reduction in the main corporation tax rate, from 33% to 30%, is estimated to have reduced receipts by £3.75bn in 2001–02.[2] But, in large part, the growth of revenues in Figure

---

[1] This cross-sectional comparison fluctuates from year to year as countries experience different stages of their business cycles. For corporate tax revenues as a share of GDP, the UK has been among the top three countries in the G7 in every year since 1980.

[2] Source: HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, November 2000.

6.1 reflects inflation: real revenues rose just 5%. Since real GDP has increased by considerably more than 5% over the four years of this Parliament, corporation tax receipts have actually declined as a share of GDP.

Still, the fact that corporation tax receipts rose at all in real terms may seem surprising, given the substantial cut in its main rate. In part, this reflects the buoyancy of the corporation tax base, itself a product of the relatively favourable economic climate during the 1997–2001 Parliament. But government policy has also been important, as structural reform of the tax's payment mechanism has raised revenue over the period. In particular, advance corporation tax (ACT), under which tax was prepaid in relation to dividend pay-outs, has been abolished and replaced by a new system of quarterly instalments for large companies. In principle, this change could have been implemented in a revenue-neutral way if, on average, the timing of corporation tax payments had not been changed. But the reform was implemented in a way that, on average, brought forward corporation tax payments.

In the four-year transition period from 1999–2000 to 2002–03, companies are in effect required to pay rather more than a single year's corporation tax bill in each tax year. Consequently, tax revenues are estimated to be around £2bn higher each year during this period.[3] This effect is temporary: after 2002–03, the only disadvantage to large companies will be the timing disadvantage implied, on average, by the requirement to make corporation tax payments earlier than under the old system.[4] Annual corporation tax receipts will be lower for this reason after 2002–03, but the transitional arrangement has made a handy contribution to tax revenue during the 1997–2001 Parliament.

## The tax treatment of dividends

Profits are not only taxed at the company level. When they are paid out to shareholders as dividends, they may be subject to income tax as well. Before 1997, this 'double taxation' was partially mitigated for all shareholders, as part of the corporation tax liability was treated like a prepayment of income tax and imputed to shareholders via a refundable dividend tax credit. Whilst this remains the case for tax-paying shareholders, the 1997 Budget abolished the tax refund for most tax-exempt shareholders, including pension funds and pension schemes run by insurance companies. This resulted in a significant gain for the Exchequer, which the government estimated would rise to exceed £5bn by 1999–2000.[5] Part of this revenue was returned to companies via the cut in corporation tax rates in the same Budget, and part was kept by the government.

The reform of dividend taxation in the July 1997 Budget, and the subsequent abolition of advance corporation tax, confirmed in the March 1998 Budget and implemented from April 1999, both addressed distortions in the tax system

---

[3] Source: Inland Revenue Press Release 9, 17 March 1998.

[4] Small and medium-sized companies, not subject to the quarterly instalments system, gained a timing advantage from the abolition of advance corporation tax if they pay dividends.

[5] Source: Inland Revenue Press Release 2, 2 July 1997.

that may have affected dividend distribution decisions and business location decisions.

Under the old system, firms paid ACT when they paid dividends, but most firms could offset this ACT payment against their next corporation tax bill. Tax-exempt shareholders had a considerable tax advantage if profits were paid out as dividends, rather than retained by the firm: for those shareholders, dividend payments came with a partial refund of corporation tax, whilst retained profits did not. Given the dominant shareholding of tax-exempt institutional investors in many large companies, there was concern that this tax incentive resulted in excessive dividend pay-outs, possibly at the expense of investment. The abolition of repayable dividend tax credits removed this distortion.

Whilst most firms could set off ACT payments against their next corporation tax bill, some firms – those in a 'surplus ACT' position – could not, and for these firms the old system actually imposed a distortion against paying out dividends. This chiefly affected companies with substantial activities abroad, whose total profits and hence dividends may have been high, but who paid corporate taxes abroad and thus had a comparatively low UK corporation tax liability. For these firms, ACT was effectively an additional layer of tax that could be reduced by paying lower dividends. Again, the abolition of ACT will remove this distortion to their dividend decisions. To the extent that such firms located high-cost activities outside the UK and highly profitable activities inside the UK in order to reduce their surplus ACT problem, these distortions to location decisions will eventually be removed.[6]

## Overall impact on government revenues

Estimates of the net effect of all these changes to the taxation of company profits and dividends are shown in Table 6.1. In contrast to the revenue charted in Figure 6.1, the significant impact of the dividend tax reform is included. This did not show up in Figure 6.1, as it represented an increase in income tax rather than corporation tax.

Overall, the table shows how, taken together, the reforms have increased revenues over the last four years: in each of the last two full fiscal years of this Parliament, the government's changes to the tax treatment of profits leave receipts over £4bn higher than they otherwise would have been. This is partly due to the transition to quarterly corporation tax payments for large firms and partly due to the corporation tax rate reductions not fully offsetting the increase in taxes on dividends affecting tax-exempt institutional shareholders.

[6] Such distortions remain so long as firms have a stock of surplus ACT accumulated under the old system and not yet relieved under the 'shadow ACT' system that now determines the rate at which these past ACT payments can be set off against future corporation tax bills.

**Table 6.1. Revenue effects of main changes to profit taxation (£ billion)**

| | 1997–98 | 1998–99 | 1999–2000 | 2000–01 |
|---|---|---|---|---|
| Tax rate cuts, July 1997 | | –1.6 | –2.2 | –2.52 |
| Tax rate cuts, March 1998 | | | | –0.78 |
| **Tax rate cuts, total** | | **–1.6** | **–2.2** | **–3.3** |
| Abolition of ACT / introduction of instalments | | 0.1 | 1.6 | 2 |
| Changes to dividend taxation | 2.3 | 3.95 | 5.4 | *5.4* |
| **Total revenue effect** | **2.3** | **2.45** | **4.8** | **4.1** |

Notes: Rate cuts include the revenue effects of cuts in the small companies' rate. Figures from the Tax Ready Reckoner have been used whenever they provide more up-to-date estimates. The figure for revenue gained in 2000–01 by changes to dividend taxation, shown in italics, is conservatively extrapolated from the 1999–2000 estimate at a constant nominal value.

Sources: Inland Revenue Press Release 2, 2 July 1997; Inland Revenue Press Release 9, 17 March 1998; HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, November 1999; HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, November 2000.

Labour has implemented reforms of dividend and corporate taxation in a way that has boosted government coffers during this Parliament. But the extra revenues produced by the transition to the new corporation tax payments system are, of course, temporary, and corporation tax receipts will be reduced by almost £3bn annually when the new payments system becomes fully operational after 2002–03.[7] Together with the healthy economic climate, these structural reforms have helped to ensure that profit taxation has made a major contribution to the healthy public finances during this Parliament. If the next government were to rely on taxes on company profits to the same extent, it may need to find new ways to increase them.

# 6.2 Tax measures for smaller companies

Small companies, like large, have seen a three percentage point fall in their corporation tax rate since 1997, from 23% to 20%. But, to a large extent, the similarities end there. The Labour government has introduced a number of tax reforms that specifically benefit small and medium-sized enterprises (SMEs) and investors in those firms. The measures have included more generous capital allowances, the introduction of a research and development (R&D) tax credit for SMEs, and the Enterprise Management Incentives (EMIs) scheme, which provides tax relief on share options for employees in smaller, high-tech companies. Capital gains tax reforms have also benefited investors in small firms. Changes have also been made to the Venture Capital Trust and Enterprise Investment Schemes, and a new Corporate Venturing Scheme has been introduced which provides tax relief on investments by firms in smaller enterprises.

Table 6.2 lists some of the measures, together with the revenue the government has forgone in introducing them. While the list of measures introduced is long, their overall impact might be expected to be small, given their relatively low cost. For example, the table shows that the new 10%

[7] Inland Revenue Press Release 9, 17 March 1998.

'starting rate' of corporation tax represents a tax cut of only £100m, because this rate applies only to the first £10,000 of taxable profits.[8] No measure listed in the table involved the government forgoing much more than £0.5bn.

**Table 6.2. Exchequer cost of selected tax reforms for SMEs, 1997–2001**

| | **2001–02 £m** |
|---|---|
| Small companies' corporation tax rate cut from 23% to 20%[a] | –540 |
| Permanent first-year capital allowances for SMEs at 40%[b] | –190 |
| 10% corporation tax rate for the smallest companies from April 2000 | –100 |
| R&D tax credit[c] | –100 |
| 100% capital allowances for ICT investment for three years[b] | –90 |

Notes: Figures are Budget measures costings from the *Financial Statement and Budget Report*, except that marked [a], which is calculated from *Tax Ready Reckoner and Tax Reliefs*. Figures are full-year costs except those marked [b] or [c].

[a] See note above.

[b] The initial cost will be partially clawed back over time.

[c] First-year cost. The full-year cost is £150m.

Sources: *Financial Statement and Budget Report*, March 2000; HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, November 2000.

Some of the reforms are aimed at changing companies' or individuals' behaviour in specific ways. For example, it is widely accepted that R&D activity will be under-provided by the free market because a substantial part of the benefit it delivers is in the form of 'spillovers', which do not accrue to the firm undertaking the investment. The R&D tax credit for SMEs is designed to address this problem, by encouraging small firms to undertake more R&D. But in such cases where there are clear grounds for wishing to subsidise a particular activity, it is far less obvious why one would want to restrict this subsidy to smaller companies. Indeed, the government seems to have recognised this in the case of R&D: the 2001 Budget proposed the extension of some form of R&D tax credit to larger firms.

Against any advantages that these fiscal reforms achieve in altering firms' behaviour in a desirable way must be weighed their negative effects. The number of measures implemented and the fact that they are restricted to specific classes of companies have added to the complexity of the tax system. Furthermore, complex fiscal reforms risk introducing unwelcome changes in behaviour – for example, in the case of the R&D tax credit, the risk is that companies may reclassify some expenditure as R&D purely to benefit from the credit.

In other cases – for example, in some of the employee share ownership schemes – there is no clear rationale recommending the introduction of the reform comparable to that in the R&D tax credit case. While the economic advantages of such schemes are less obvious, the risks of increasing complexity and distorting behaviour remain.

[8] Companies with taxable profits between £10,000 and £50,000 also derive some benefit from the 10% rate.

## 6.3 Windfall tax

The incoming Labour government implemented a one-off windfall levy on privatised utility companies in its first Budget in July 1997. Although ostensibly introduced to finance the New Deal welfare-to-work programme for young people, the merits of the tax should be considered separately from the merits of the expenditure with which it is notionally linked. Nothing of substance would have been different if the proceeds of the windfall levy had been allocated to (say) military spending while other taxes had been said to cover the New Deal.

The tax raised around £5.2bn in two instalments from a group of over 30 utilities that were privatised by flotation and subject to regulation. This included the water companies, regional electricity companies and electricity generators, as well as British Airports Authority, British Gas (BG and Centrica), British Telecom and Railtrack.

The tax was based on the difference between the value at which each firm was privatised and a 'more realistic' valuation based on after-tax profits in the first four years after privatisation. If the aim of the tax was to reclaim for the taxpayer the gains made by those who bought nationalised assets at a discount, it was unable to achieve this fully. For the investors who made 'windfall gains' by selling their shares soon after privatisation were long gone by the time the windfall levy was announced. The shareholders hit by the levy were those unlucky enough to be holding utility shares when news of the levy was capitalised into utility share prices.

Retrospective increases in taxation create uncertainty about the future tax environment among firms contemplating investments, and this uncertainty might be expected to deter some investment. Perhaps in recognition of this argument, the government has stuck to its word that this was a one-off levy on the utilities and has resisted the temptation to introduce further 'windfall taxes' on banks or North Sea oil producers.

## 6.4 Climate change levy

A new tax on business use of energy was announced in the 1999 Budget, following recommendations of the 1998 Marshall Report.[9] A modified version of this climate change levy will be introduced from April 2001.

The levy covers energy use in the business, public and agriculture sectors, which jointly account for around a third of $CO_2$ emissions.[10] The levy is part of a wider package of measures aimed at reducing greenhouse gas emissions, to meet government targets including that agreed at the 1997 Kyoto conference on climate change.

---

[9] *Economic Instruments and the Business Use of Energy*, HM Treasury, London, 1998.

[10] DETR, *Climate Change: The UK Programme*, November 2000 (http://www.environment.detr.gov.uk/climatechange/).

The original blueprint envisaged a levy that would raise £1.75bn per annum, accompanied by a cut in employer National Insurance contributions (NICs) of 0.5 percentage points. The levy introduced will raise around £1bn per annum, with a cut in employer NICs of 0.3 percentage points. Overall, this package is intended to be revenue-neutral, although labour-intensive sectors will benefit more from the reduction in employer NICs than capital-intensive sectors.

The case for the climate change levy depends partly on the extent to which business responds by finding more energy-efficient forms of production, thereby paying less tax and producing lower emissions, or by relocating energy-intensive production processes to countries with lower environmental taxes or standards of regulation, thereby paying less tax with no benefit to global greenhouse gas emissions. Concern over the impact of the levy on the competitiveness of the UK as a location for production led to the reduction in the scale of the levy and to the introduction of Climate Change Levy Agreements in the major energy-using sectors, including chemicals and steel. Under these agreements, firms that meet targets for introducing 'cost-effective energy efficiency measures' will receive an 80% discount on the climate change levy.

This illustrates a major problem for individual countries wishing to introduce tough environmental taxes on companies or, for that matter, wishing to introduce tough environmental regulations. Where firms are able to relocate production to countries with lower environmental taxes or lighter regulations, the ability of these measures to achieve their objective of lower *global* emissions is hampered. In theory, the solution to this conundrum would be greater international co-operation on environmental taxes and regulations aimed at mobile business activities. In practice, this may prove extremely difficult to achieve.

*Stephen Bond, Alexander Klemm and Helen Simpson*

# 7. The main parties' tax and spending proposals

This chapter looks at the planned levels of borrowing under Labour, the Conservatives and the Liberal Democrats and the differences in terms of tax and public spending for the period up to March 2004. In addition, we analyse differences between the parties in their plans for expenditure in particular fields.

## 7.1 Plans for public borrowing

There is currently little disagreement between the three main parties about the appropriate levels of public borrowing, at least in the period to March 2004. Both the Labour Party and the Liberal Democrats have committed to keeping to the 'golden rule' that Gordon Brown adopted in the July 1997 Budget.[1] Although the Conservatives have not explicitly committed themselves to this, their tax and spending plans imply similar levels of borrowing to those forecast by Gordon Brown going forward to 2003–04, i.e. planning for the cyclically adjusted surplus on current budget stabilising at around 0.6% of GDP.

Should either Labour or the Liberal Democrats win the next election, there may be a further constraint on fiscal policy. This is because both parties have, subject to a referendum, left open the possibility of joining the single European currency in the next Parliament. Joining or being in a position to join the single currency formally requires UK fiscal policy to be set in accordance with the Growth and Stability Pact. This requires member countries to plan for a balanced budget. Planning in this way implies either higher taxes or lower public spending than just meeting the golden rule, since it prohibits the government from borrowing to invest.

### Is a balanced budget rule more desirable than the golden rule?

The golden rule makes a distinction between current spending and capital spending on the basis that current spending is considered to benefit only the current generation while capital spending is considered to be an investment that will be of benefit in the future as well. A balanced budget rule would not recognise a difference between current spending and investment spending. As long as there is a genuine benefit to future taxpayers from an element of government spending, it seems reasonable that they should contribute towards its cost. An analogy is with individuals, who do often choose to fund purchases for the long term by borrowing – for example, by taking out a loan to buy a car or a mortgage to buy a property. Another example is companies, which often borrow to carry out investments.

[1] For more detail on the 'golden rule', see Chapter 2.

One criticism of the golden rule has been that the distinction between capital and current spending is inadequate: it implicitly assumes that future generations only benefit from spending that falls under the National Accounts capital category. But this categorisation may be crude, and some spending classed as current, such as some education spending, might actually benefit future generations. The golden rule risks inappropriately preventing such spending.

The danger with a balanced budget rule is that it would aggravate this situation by ruling out any spending being financed by future generations. This seems undesirable, since investment projects that were extremely beneficial to society as a whole but prohibitively expensive to finance from current taxpayers alone would not go ahead under a balanced budget rule.

## 7.2 Tax and spending: how big is the choice on offer?

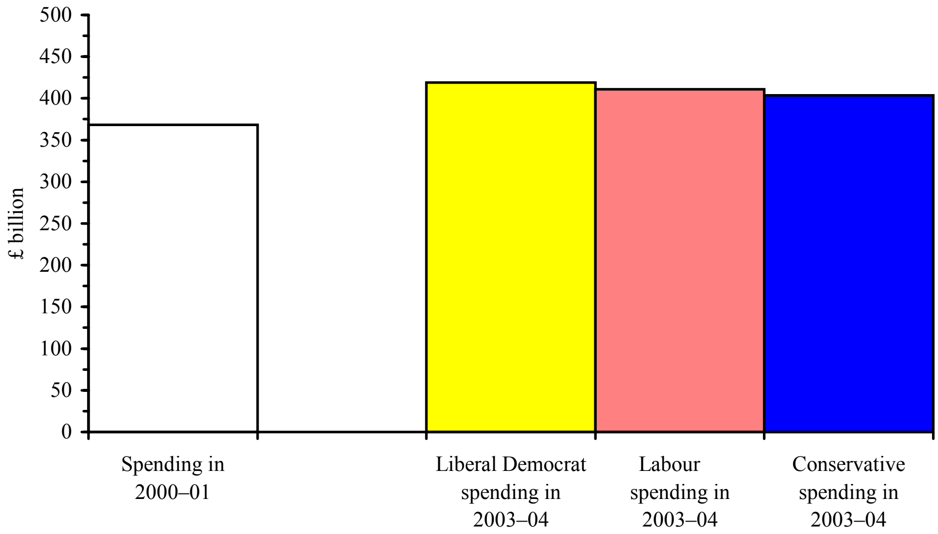
All three major parties have outlined spending plans for 2003–04, the last year of Labour's Spending Review 2000 plans. The Conservatives' plans represent £8bn less government spending compared with Labour, while the Liberal Democrats are proposing spending that is higher than Labour's plans by £8.6bn.

How big is this difference? Figure 7.1 shows total real spending under Conservative, Liberal Democrat and Labour plans, and shows that, relative to total government spending, the differences seem modest. In fact, the £8bn cut that the Conservatives advocate represents a reduction of just 1.8% of the £442.6bn that the Labour Party is proposing to spend in 2003–04; alternatively, this should be around 0.7% of national income. The Liberal Democrat plans involve moving by a very similar magnitude in the opposite direction. While these differences in public spending are relatively small as a share of national income, if focused on particular public services their effect on service quality could be amplified.

In nominal terms, we could expect to see spending increase by £66.3bn between 2000–01 and 2003–04 under the Conservatives, by £74.3bn under Labour and by £82.9bn under the Liberal Democrats. The lower growth in spending proposed by the Conservatives is not sufficient to stop public spending as a share of national income growing between 2000–01 and 2003–04.

None of these proposed levels of public spending would significantly alter Britain's ranking in the international public spending league table that appears in Chapter 2. In the low-spending US, the public sector is almost 10% of GDP smaller than in the UK, while in high-spending countries, such as Denmark and Sweden, public spending is up to 15 percentage points higher.

**Figure 7.1. Planned public spending under a Labour, Conservative and Liberal Democrat government in 2000–01 prices**




Source: HM Treasury, *Financial Statement and Budget Report, March 2001*, Hc279, The Stationery Office, London, 2001 (http://www.hm-treasury.gov.uk/budget2001/index.html); Conservative manifesto (The Conservative Party, *Time for Common Sense*, 2001); Liberal Democrat manifesto (The Liberal Democrats, *Freedom, Justice, Honesty*, 2001).

But the choice might seem more significant if it is seen as being between embarking on alternative paths that would continue to diverge after 2003–04. Table 7.1 shows the average growth rate of public spending under each of the three parties' plans. If the parties' preferred growth rate for public spending over the next three years were to persist across a five-year Parliament, or, indeed, even beyond it, then the difference in the level of public spending would become far more significant.

**Table 7.1. Public spending: the main parties' proposals**

| | Planned annual real growth in spending to 2003–04 | Planned spending as % of GDP in 2003–04 | Planned increase in spending as a share of GDP to 2003–04 |
|---|---|---|---|
| Labour | 3.7 | 40.3 | 1.4 ppt |
| Conservatives | 3.1 | 39.6 | 0.7 ppt |
| Liberal Democrats | 4.4 | 41.1 | 2.2 ppt |

ppt = percentage point.
Notes: Unlike in Table 2.1, spending financed by the windfall tax is included; this increases measured spending in the base year, and so reduces the measured rate of spending growth. As a result, figures for growth in total spending under Labour's plans in this table are slightly lower than those reported in Chapter 2.

The Conservatives have argued that, in the longer run, public spending should not grow faster than national income. This would allow reductions in taxation or borrowing as a share of national income towards the end of the Parliament. It would also mean that growth in at least some areas of public spending would have to be lower than it is set to be over the next three years. In particular, if the Conservatives were to try to continue the large increases in health and education spending that they are committed to for the next three years, there would have to be extremely low growth in other areas of public spending. Still, it is not obvious that differences in public spending growth that the parties have planned can confidently be extrapolated forward in this way – for example, because Labour has not, as yet, announced plans for public spending beyond 2003–04.

A final way in which we might gauge the scale of the choice available in this election is to contrast it with that on offer in other recent elections. There is now perhaps more of a gap between the main parties on public spending than there was in 1997, when Labour pledged to stick precisely to the Conservative plans for total public expenditure for their first two years in office. By contrast, the choice on offer in 1992 was slightly more significant than that being presented today. Labour's early commitments to extra public spending implied an increase in total spending of 2.6% by way of comparison with the projections of the Conservative government after three years in office.[2]

We now turn to look more closely at the choices between the parties in terms of their spending commitments in individual areas.

# 7.3 Spending on the NHS

There is little disagreement between the government and the Conservative Party over total NHS spending, at least as planned over the next three years. The Conservatives have pledged to match government plans until March 2004. But the Liberal Democrats propose additional total spending of £1.6bn by 2003–04. Since the NHS budget in that year is forecast to be almost £69bn, this is equivalent to an increase of 2.3%. Labour and Conservative plans imply annual real increases in NHS spending of 5.7%, while the Liberal Democrats budget for 6.5% a year. Both figures represent growth in health spending that would be large by historical standards.[3] The Liberals assert that their plans would, amongst other things, allow higher NHS pay, expanded training and free personal care for the elderly, but these plans would depend on successful delivery of savings on the NHS drugs bill.

In spite of relative agreement on the appropriate level of total NHS spending over the short term, there is debate over the detail of policy. Both the Conservatives and the Liberal Democrats have proposals to reduce the demands placed on the NHS budget. We assess each in turn, before considering alternative means of targeting improvements in the NHS.

## Subsidising private medical insurance

One way in which the gap between health spending in the UK and that seen elsewhere could be closed is through growth in the role played by the private

---

[2] Calculation based on information in E. Davis et al., *Alternative Proposals on Tax and Social Security*, Commentary no. 29, IFS, London, 1992.

[3] For more details, see Section 3.1.

sector. While the private sector already plays a significant role in the provision of healthcare in the UK, it is much smaller than the role played elsewhere. Increased use of privately financed healthcare should save NHS spending that would otherwise have gone on those who have chosen to pay privately. The Conservative Party's manifesto states that

> 'Labour imposes a tax penalty on employers who offer their employees private medical insurance, and then taxes any employee who has this benefit. It doesn't make sense and, when affordable, we will abolish both taxes'.

Removing employers' and employees' National Insurance from employer-provided private medical insurance (PMI) would cost the government nearly £½bn in lost revenues. It would lead to an increase in the numbers covered by PMI schemes, and hence a reduction in demands on the NHS. An alternative use of the £½bn would be simply to increase NHS spending. An interesting question is whether such a subsidy on the purchase of PMI would be self-financing in that its cost is more than outweighed by the savings made by the reduction in demands on the NHS. This seems unlikely for two reasons:

1. There are currently 6.4 million individuals with PMI, two-thirds of which is provided through an employer.[4] These individuals would receive any tax relief given on PMI without giving any additional benefit to the NHS.[5]
2. It is not the case that an additional pound of spending on PMI leads to a reduction in demand of £1 on the NHS, since the NHS is likely to be able to provide healthcare more cheaply than the private sector. This is because PMI clearly offers a better quality of service in at least some dimensions – for example, private rooms with *en-suite* bathrooms. In addition, it is possible that the NHS is able to pay lower wages than the private sector. There is evidence that consultants' pay is lower in the NHS than in the private sector.[6]

## Saving on the NHS drugs bills

An alternative way of improving the quality of the NHS, without further increases in spending, is to try to save on elements of current spending. If such savings were possible without any adverse consequences, we might expect any party would undertake them.

The Liberal Democrats argue they could save substantially on the NHS drugs bill, by almost £500m in 2003–04 and by more in subsequent years. The drugs bill currently stands at £6bn a year. It is largely determined by drugs prices, which are in turn set by government regulation. The Liberal Democrats' proposed savings would be delivered by lowering these prices: according to its

[4] Laing and Buisson, *UK Market Sector Report 2000,* Laing & Buisson Publications Limited, 2000.

[5] For a more detailed discussion of these issues and for estimates of the price elasticity of PMI, see C. Emmerson, C. Frayne and A. Goodman, 'Should private medical insurance be subsidised?', *Health Care UK*, Spring 2001 (www.ifs.org.uk/healthindex.shtml).

[6] Monopolies and Mergers Commission, *Private Medical Services*, Cm. 2452, HMSO, London, 1994.

manifesto, the party would 'use the purchasing power of the NHS to drive down the price of established drugs and secure the more sophisticated medicines and drugs at lower prices'.

If the policy could be successfully implemented, it would save resources in the highly stretched NHS. Further, there is a sense in which the policy would increase economic efficiency. Typically, producing an extra course of drugs costs a company far less than the sales price charged to the government. This means high prices will very likely deter the NHS from purchasing drugs in some cases, even though the value of the benefit to the patient exceeds the cost to the drugs company of providing it.

But cutting drugs prices runs risks. First, lowering the prices of new drugs may blunt the incentive to innovate that the profits earned in pharmaceuticals deliver. This effect might be thought small, as most profits are earned outside the UK, which accounts for only about 4% of the global drugs market. But lower UK prices would have more effect if they triggered lower prices elsewhere. They might do this in two ways:

- directly, in countries such as Italy, Austria and Holland, which set their own drugs prices on the basis of an international reference pricing system;
- indirectly, particularly in the US. Prices in the US are already more than double those in the UK, so there is already strong pressure for reductions, which price cuts in the UK might strengthen – especially since the UK has a similarly large pharmaceutical industry.[7] Since the US accounts for about half of the world drugs market, any price cuts there would have potentially drastic effects on incentives.

An additional risk is that the large UK pharmaceutical industry, which employs about 60,000 people, would respond to aggressive price cuts by relocating overseas. If this risk is seen as significant, besides the effect on jobs, the effect on government coffers of the forgone corporation tax and other taxes must be considered.

## Measuring quality in the NHS

The 1997 Labour manifesto pledged to reduce waiting-lists by 100,000. In March 1997, there were 1,158,000 people on an in-patient waiting-list in England. In February 2001, this figure stood at 1,033,000 – which is a reduction of 125,000, so the pledge has been met.[8] But, by historical standards, the number waiting for treatment remains large. While waiting-lists have existed since the birth of the NHS in 1949, the number on them never exceeded 1 million until March 1993.[9]

[7] This is discussed in N. Bloom and J. Van Reenen, 'Regulating drugs prices: where do we go from here?', *Fiscal Studies*, vol. 19, pp. 321–42, 1998.

[8] Latest waiting-list statistics from Department of Health Press Release 2001/0180, *Statistical Press Notice: NHS Waiting Lists – February 2001*, 6 April 2001 (www.doh.gov.uk/public/statpress.htm).

[9] C. Emmerson, C. Frayne and A. Goodman, *Pressures in UK Healthcare: Challenges for the NHS*, Commentary no. 81, IFS, London, 2000 (www.ifs.org.uk/health/nhsspending.pdf).

But, however these figures are interpreted, is the focus on the length of waiting-lists useful? Exclusive focus on waiting-lists can be especially misleading. For example, while the in-patient waiting-list has shortened since March 1997, the number of people waiting for more than 12 months has increased by 45% to 31,300. Patients presumably care about the time they have to wait and the quality of care that they eventually receive. Waiting-lists are not necessarily related to either of these.

No single statistic accurately captures NHS quality, but alternative targets to waiting-lists, such as waiting times, might be more closely related to meeting patients' needs, especially if different targets are set for different conditions. Perhaps in recognition of this, the 2001 Labour manifesto focuses on reducing maximum waiting times as opposed to waiting-lists.[10] Likewise, the Conservative Party's manifesto proposes a 'patient's guarantee' on maximum waiting times, which would be set dependent on the gravity of the patient's specific condition.

But even such refined targets can pose problems. In April 1999, the current government pledged that all patients with suspected breast cancer would see a specialist within two weeks of being referred by their GP.[11] This proved hard to deliver, although 95.6% of affected women in England were seen within the two-week target by the end of 2000, a small number were not.[12] Diverting considerable resources to ensuring such a target was met in 100% of cases is unlikely to represent the optimal way to use resources to meet clinical priorities.

Explicit targets provide transparent criteria of NHS success which might help galvanise its managers to improve quality. The danger is that they will be targeted at the expense of all else and that clinical priorities will be distorted in consequence.

# 7.4 Spending on education

As with the NHS, the Conservatives have pledged that they will match the substantial increases in education spending that Labour has planned until 2003–04. The Liberal Democrats have pledged that they will spend an additional £3.1bn in 2003–04, which they will finance through a 1p increase in the basic rate of income tax.[13] This extra money is equivalent to 5.5% of

[10] The Labour Party, *Ambitions for Britain*, 2001.

[11] This pledge was first made in Department of Health, *The New NHS, Modern, Dependable*, The Stationery Office, London, 1997 (www.official-documents.co.uk/document/doh/newnhs/newnhs.htm).

[12] Department of Health Press Release 2001/0122, *Statistical Press Notice: Waiting Times for Suspected Breast Cancer Patients Quarter Ended 31st December 2000*, 8 March 2001 (www.doh.gov.uk/public/statpress.htm).

[13] This is a similar, but not identical, policy to the one that the Liberal Democrats had at the 1997 election, since increasing the basic rate of income tax now raises far more than it did in 1997. This is because, in addition to changes in employment and incomes, the 10p starting rate, introduced from April 1999, replaced the wider 20p lower rate. The result is that the basic-rate band now covers a wider range of income than previously was the case.

planned education spending in that year. As a result of these pledges, education spending over the next three years would increase by an average of 7.5% a year under the Liberal Democrats compared with 5.6% under either Labour or the Conservatives. Spending as a share of GDP would rise to 5.6% of GDP, compared with 5.3% under either of the other two main parties.

Labour has pledged to use some of the increase in spending over the next three years to employ an additional 10,000 teachers. This is an increase of about 2%. The additional spending proposed by the Liberal Democrats is intended, among other things, to be used to employ additional teachers and classroom assistants and to abolish tuition fees for higher education.

## Alternative means of delivering education spending

Currently, the responsibility for school provision rests with local authorities rather than with central government. Local councils receive a general grant, which they may allocate across their spending responsibilities in order to meet local priorities. In addition, councils can, if they wish, increase the council tax in order to increase total spending on local services. In both these ways, they can alter their education spending.

But the central government's education policy also clearly has a great deal of influence on schools, and the current government has attempted to exert a more direct influence on schools' finance than has traditionally been the case. In particular, it has tried to increase school spending by announcing new payments that go direct to schools after local councils have set their annual budgets, as opposed to increasing the finance received by local councils. This happened in both the March 2000 (£1bn) and the March 2001 (£0.3bn) Budgets. Yet, under the current arrangements, it is not possible for central government to guarantee increases in funding received by schools since councils could adjust their planned budgets in anticipation of any 'additional' funding.

The Conservative manifesto proposes to take this process of direct finance further:

> 'We plan to spend [on education] what the government has planned. We will save money currently wasted on government and council bureaucracy, giving this money directly to schools according to the number of pupils.'

Several issues raised by this policy are beyond the scope of this chapter. But the proposal does highlight the trade-off to be considered when fixing the appropriate level of local autonomy over public service spending.

The current system of locally elected councils determining the level of spending on education has the advantage that, if some areas of the country would like to have higher spending, they can fund this through higher council tax on local residents.[14] Conversely, if an area would like to spend less, in

[14] Under the current funding arrangements, an additional £1 in local spending leads to a £1 increase in local taxes. The only exception to this is the proportion of council tax bills paid through council tax benefit. Under rules introduced by the current government, councils with

return for lower taxes, the local council has the choice of adjusting its spending according to residents' wishes. The system increases the amount of choice individuals have about how they wish their taxes to be spent. A similar debate is whether the European Union should be allowed to dictate the levels of public spending and taxes in member countries, or whether they should remain free to make their own choices over the levels of taxation and spending that they would prefer.

There are also some strong arguments in favour of direct funding of schools. It may be the case that we do not want to see education provided as a local service since, as a society, we may decide that regional variations in quality are not acceptable. This is currently the case with healthcare, since NHS funding across England, Wales and Northern Ireland is both determined and allocated centrally.[15] Of course, this does not guarantee that there will be no regional variations in the quality of service provided – there are clear examples of regional variations in the quality of the NHS.[16] It would, however, make more uniform standards of service easier to achieve – which was the main objective of the introduction of the national curriculum back in 1988. In addition, if most voters see central rather than local government as responsible for the standard of education provided in their local schools, then, all else being equal, concentrating political responsibility in central government could enhance electoral accountability.

## 7.5 Social security spending

All three main parties have pledged further social security reform. If successfully implemented, the Conservatives' proposals would reduce spending by a total of around £2.5bn,[17] while the Liberal Democrats' proposals for benefit reform would increase costs by a total of £2.9bn. More details of these reforms can be found in Chapters 8 and 9. The planned real annual increase in costed proposals for social security spending over the next three years would average at most 1.5% under the Conservatives, 2.2% under Labour and 3.0% under the Liberal Democrats.

In fact, should Labour be re-elected, the actual planned increases in spending may turn out to be greater than this. The Labour Party has proposed several

---

increases in council tax above a centrally determined bench-mark level have to fund part of the increase in council tax benefit liabilities themselves.

[15] The Scottish Parliament does have limited tax-raising powers, which could be used to increase, for example, NHS spending. So far, it has chosen not to use these powers. The Scottish Parliament does have the ability to allocate funds between spending areas, including the NHS.

[16] See Chapter 6 of C. Emmerson, C. Frayne and A. Goodman, *Pressures in UK Healthcare: Challenges for the NHS*, Commentary no. 81, IFS, London, 2000 (www.ifs.org.uk/health/nhsspending.pdf).

[17] This assumes that none of the bureaucracy savings proposed by the Conservatives fall within the Department of Social Security. In addition, we ignore the extra expenditure flowing from the Conservatives' proposed state pension increase, but also offsetting savings on the working families' tax credit, the New Deal and the Social Fund.

further reforms to the social security system that are still under consultation. These proposals remain uncosted and are not included within the current spending totals. They include the introduction, from April 2003, of the employment tax credit, the integrated child credit and the pension credit. IFS estimates suggest that, in total, they are likely to cost around £2½bn a year. Furthermore, there are manifesto commitments to introduce the Child Trust Fund and the Saving Gateway at some point in the next Parliament.[18]

The Conservatives have also proposed further reform to the UK pension system. This will allow younger individuals to choose between retaining their entitlement to the basic state pension or forgoing entitlement in return for lower National Insurance contributions. In the long run, it is not certain whether this policy would strengthen or weaken the public finances, but social security spending on pensions would fall. In the shorter term, this policy would have a net cost to the government, since National Insurance contributions would decline but pension expenditure would be unaffected until some time in the future. For more details of this proposal, see Appendix A.

# 7.6 Other areas of government spending

Both the Conservative Party and the Liberal Democrats have pledged to keep to Labour's spending plans for defence.

The Conservatives have also pledged to keep to the Labour Party's spending plans on law and order, while the Liberal Democrats have pledged a relatively small increase in funding of £200m. The Conservative Party's manifesto contains a number of law and order reforms that might have cost implications, although it might be possible to meet these within the planned total if spending in other parts of the law and order budget is tightly controlled.

Under both Labour and the Conservatives, spending on international development is set to grow by an average 4.9% a year in real terms. The Liberal Democrats have also pledged additional funding, sufficient to raise this growth to 6.3% a year. Since the overall budget is relatively small, this increase in funding only costs an extra £125m by 2003–04, though under the Liberal Democrats this increase would reach £500m by 2005–06.

It will always be the case that, for a given level of public borrowing, higher or lower levels of public spending as a share of national income imply higher or lower levels of taxes. A discussion of the choices possible beyond March 2004 is contained in Appendix B.

*Nicholas Bloom, Carl Emmerson and Christine Frayne*

[18] For more details of all these policies, see Chapter 10.

# 8. The Conservatives' proposals

The Conservatives have made several proposals for tax and benefit reform, including benefit changes, reforms to savings taxation, a cut in fuel duty and a package of tax cuts for families. This chapter analyses how these measures would affect household disposable incomes, how much they would cost and what the implications for the structure of the tax and benefit system might be. The chapter closes with a look at the Conservatives' longer-term aspirations.

## 8.1 Tax cuts for families

The Conservatives plan to reduce income tax for families with children by:

- making personal allowances transferable for married couples with children aged under 11;
- increasing the children's tax credit for children under five;
- more generous tax treatment of widowed parent's allowance.

We consider each of these measures in turn and then look at the overall distributional effect of the package.

### A transferable allowance for married couples

Under present legislation, the income tax personal allowance – a band of income someone can receive in a year without having to pay income tax – is a fixed amount for each individual, regardless of personal circumstances. This means that each partner in a couple of working age can earn up to £4,535 in the 2001–02 tax year without paying income tax. If the couple only has one earner (e.g. a wage-earning wife and a househusband), the partner not in paid work cannot transfer his or her allowance to the working partner. The Conservatives argue that this situation is inequitable because it means that a single-earner couple (e.g. with one partner earning £30,000 p.a.) often pays more tax overall than a two-earner couple with the same gross earnings (e.g. £15,000 p.a. each).

The Conservatives propose to make the personal allowance *transferable* for some families: in married couples where one partner's income is below the personal allowance level, the unused part of the allowance could be transferred to the other partner to reduce that partner's tax bill. To qualify for transferability, a couple would have to have a child aged under 11 and/or be in receipt of invalid care allowance in respect of a relative. The maximum value of the transferred allowance would be restricted to the basic rate of income tax (i.e. a maximum of 22% of £4,535 or £997.70 in the case where one partner has no taxable income and transfers his or her entire allowance to the other partner). In isolation, the cost of this reform to the exchequer is estimated at around £1bn.

***Arguments for and against the transferable allowance proposal***

As intimated above, the main argument for making personal allowances transferable is that the present system biases income tax treatment in favour of two-earner couples and against single-earner couples, because a two-earner couple can use two sets of personal allowances whereas a single-earner couple can only use one. The Conservative view is that this situation is unfair, and if net household income were the only relevant criterion for assessing fairness of the tax system, this argument would seem valid.[1] However, it is not clear that two-earner couples have an advantage in living standards over one-earner households that is proportional to their tax advantage. The (unpaid) labour of a non-working partner surely makes a positive contribution to the living standards of single-earner couples, whilst single-earner couples with children will probably incur much lower childcare costs than two-earner couples.

Additionally, the transferable allowance plan introduces an interaction between the marginal tax rates faced by first and second earners. Under the current system, husbands and wives face the same marginal income tax rate structure in most circumstances. However, under the Conservative proposal, in a couple with a non-working wife and a husband who earned enough to use up the whole of the wife's transferred allowance, if the wife were to enter work, her partner would effectively pay 22p extra tax for every £1 of income she earned up to the personal allowance limit. This means that labour market participation by a second earner would be discouraged under the Conservative proposal relative to the current situation. Given that many potential second earners will be married women seeking to re-enter the labour market after having children, the Conservative plan seems effectively to discourage this.

## A more generous children's tax credit

The Conservatives are proposing an increase of £200 per year in the value of the children's tax credit (CTC) for parents with children under the age of five. In the March 2001 Budget, the Chancellor announced that the CTC would be increased by £520, or £10 per week, for couples with a baby under 12 months old. The Conservatives propose to increase the CTC by £3.85 per week, or £200 per year, for families with children aged between 12 months and five years. The estimated cost of this increase is just over £300m.

Labour's 'baby credit' and the Conservative under-five credit are examples of a move on both sides of the political spectrum towards increased support for young children in the tax–benefit system relative to older children. This is reinforced by recent increases in the Sure Start maternity grant for new mothers on means-tested benefits and by real-terms increases in the value of benefits for children under 11 in the working families' tax credit (WFTC) and income support. This favourable treatment for families with young children may seem surprising, given that most research on the relationship between

[1] Note, however, that the use of household income as the sole measure of well-being in a family is not uncontentious. If, for example, husbands and wives did not share their income, then a family where a husband received 100% of a given amount of household income would have a very different distribution of welfare between husband and wife compared with a household where the husband and wife received the same total amount but 50% apiece.

household size and living standards indicates that older children are more expensive to families than younger children.[2] However, to the extent that childbirth and its immediate aftermath involve a high cost to mothers and to families, increases in state support for new mothers can be justified on equity grounds. Also, mothers with young children are more likely to be out of the labour market (or working part-time rather than full-time) than mothers with older children, and so the extra payments for young children could be viewed as some compensation for forgone earnings.

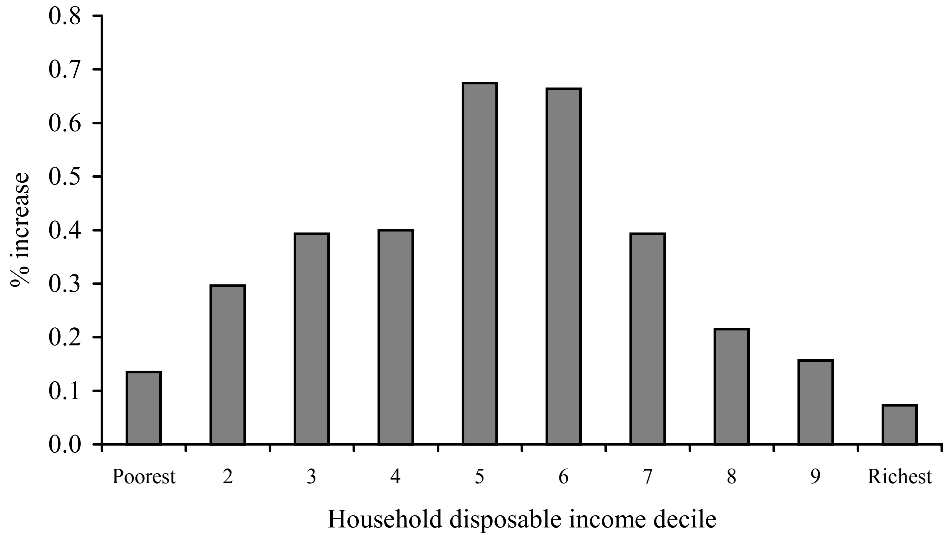
## Changes to widowed parent's allowance

In April 2001, widowed parent's allowance replaced widowed mother's allowance as a regular benefit for widow(er)s with dependent children. It is set at roughly the same level as the basic state pension plus any SERPS accrued by the deceased spouse, with an additional amount per dependent child. Currently, although the child additions are non-taxable, the main benefit is taxable. The Conservatives propose to make the entire allowance non-taxable. This reform would be expected to cost around £50m.

## Distributional effects of the family tax package

Figure 8.1 shows the combined effects of the Conservative family tax package on the distribution of household disposable incomes, divided into deciles (10 equally sized portions), ranked from poorest to richest. The overall cost of the package is estimated at around £1.3bn.

**Figure 8.1. The distributional effects of the family tax package**




Source: IFS TAXBEN model, run on Family Expenditure Survey data for 1997–98.

[2] This is discussed in more detail in Chapter 3 of M. Brewer, M. Myck and H. Reed, *Financial Support for Families with Children: Options for the New Integrated Child Credit*, Commentary no. 82, IFS, London, 2000.

The graph shows that these reforms have the largest effect in percentage terms at the 5th and 6th deciles of the income distribution. Above and below these, the effects taper off. At the foot of the distribution, average gains are small, largely because the poorest families pay little or no income tax in general. At the top, average gains are lower partly because the maximum gains from the transferable allowance and CTC reforms – which are fixed cash amounts – are a lower percentage of annual income for the richest households than for those in the middle of the distribution. In the case of the transferable allowance reform, the top deciles contain a larger proportion of two-earner couples (who would not gain from the reform unless one partner's earnings are very low) than single-earner couples (who are more likely to gain from the change); single-earner couples are more likely to be located in the middle of the income distribution, where the largest percentage gains are. Also, families in the top deciles tend to have fewer children on average (especially younger children) and so are less likely to gain from transferable allowances and the CTC increase, which are limited to families with children aged under 11 and under five respectively. In cash terms, the family package is worth an average of £9.39 per week for single-earner families with children and £2.89 per week for two-earner families with children.

# 8.2 A tax cut for savers

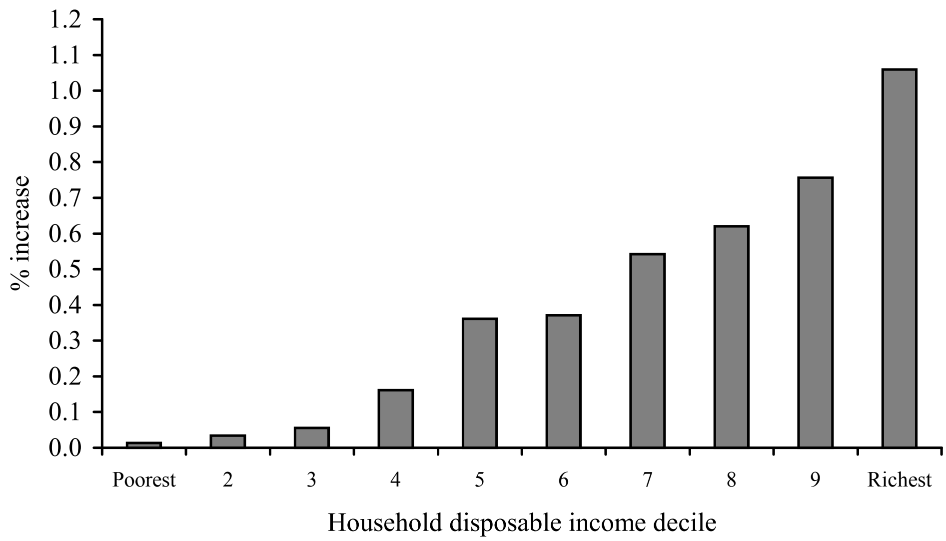
The most expensive single element of the Conservatives' tax-cutting package is their plan to abolish income tax on savings interest and dividends for everyone except higher-rate taxpayers. The current system already provides for tax-free saving, notably through Individual Savings Accounts (ISAs). But these are subject to strict annual limits, and the return on any funds held in addition to these is liable to income tax.

All taxpayers have 20% of bank or building society interest deducted at source. This is the final levy on basic-rate taxpayers, but starting-rate taxpayers can then claim half the deduction at source back, leaving their tax rate on interest at 10%, and higher-rate taxpayers face an additional tariff on their savings after completing their tax returns.

Under the Conservative proposal, no income tax would be deducted at source, and no tax would be paid at all by starting- or basic-rate taxpayers. Income from dividends would also be tax-free below the higher-rate threshold. For higher-rate taxpayers, any savings income held in excess of the higher-rate threshold, where savings income is viewed as the top tranche of income, would continue to be liable to 40% tax.

The Conservatives' estimate of the cost of the savings tax cut is around £3bn. Figure 8.2 presents IFS's estimate of the distributional effects of the reform. It shows that the poorest 30% of households gain very little from the reform – partly because they have little or no savings income on average, but also because their total income from all sources is less than the value of their personal allowance, so they pay no income tax. The average gain is 0.3% or greater for households in the top 60% of the income distribution. In the richest 10% of households, average gains are large – around 1.1% of disposable income. Thus the Conservative reform has a regressive distributional effect. A few households would realise substantial gains; any individual with more than £29,400 of taxable savings income (the higher-rate limit) and no income from earnings would gain £5,880 a year, as all his or her savings income below the higher-rate limit would become non-taxable. However, the fact that higher-rate taxpayers would continue to pay tax on savings above the higher-rate threshold means that the reform is far less regressive than it would otherwise be. Someone whose earned income alone was greater than the higher-rate threshold would not gain anything from the reform, as savings income is taxed as the top 'tranche' of income.[3]

**Figure 8.2. The distributional effects of changes to savings taxation**




Source: IFS TAXBEN model, run on Family Expenditure Survey data for 1997–98.

Is the Conservative proposal a good idea? There are some reasons for thinking it is, on pure efficiency grounds. If investments are made out of earned income (which is mostly subject to tax), the objection to a tax on savings income is that it is double taxation of a sort, which distorts the choice between current consumption and saving for future consumption. The Conservative reform would go some way towards correcting this distortion.

There is also a more pragmatic argument in favour of the proposal. Given that every adult can save £3,000 in cash or £7,000 in stocks and shares each year in an ISA under current rules, if people took full advantage of this, then the vast

[3] When analysing Figure 8.2, it should be borne in mind that the Family Expenditure Survey (FES) data significantly underestimate the level of savings holdings compared with National Accounts data (see, for example, Chapter 2 of J. Banks and P. Johnson (eds), *How Reliable Is the Family Expenditure Survey?*, IFS, London, 1998). Thus the overall gains from the savings tax cut will probably be greater than those shown here, although we have no way of knowing in which deciles the gains are under-measured in the FES. On the other hand, the FES data used here are from 1997–98, before ISAs were launched. This may cause a tendency to overestimate the gains from the policy, as, to the extent that households have shifted previously taxable savings into ISAs since 1999, they already pay no tax on savings income and so would not benefit further from the Conservative proposal.

majority of people would pay no tax on their savings income even under existing rules. However, in practice, this is not the case: a recent IFS report found that 'in spite of the proliferation of new savings vehicles, the majority of people still hold the majority of their [financial] wealth in conventional forms such as interest-bearing accounts at the bank or building society'.[4] There are several possible reasons for this: individuals might need to move savings in and out of accounts regularly, in which case ISAs are not suitable; or there might be 'hassle costs' involved in closing accounts with small sums in them and transferring into an ISA. However, the Conservative plan has the merit of extending the tax-free savings environment to many small savers who are currently missing out, for whatever reason; this equalises the savings tax regime for all basic-rate taxpayers. Also, individuals on the 10% marginal rate currently need to apply for a rebate to claim back the tax charged at 20% at source on their savings; this is an administrative complication that would be eliminated if savings tax on these people were abolished.

On the other hand, it can be argued that there are dangers in the Conservative proposal from the perspective of horizontal equity in the tax system. Under current inheritance tax rules, an individual receiving an inheritance bequest of up to £242,000 and no other income, and investing the bequest for an annual income lower than the higher-rate threshold, would pay no tax under Conservative plans; this would make his or her tax treatment substantially more lenient than another individual with the same gross income but from earnings rather than investments. Under the current system, such a tax-free investment income could only be built up piecemeal by using the ISA allowance of £7,000 per person per tax year. Another possible tax loophole is that individuals with control over the form that their remuneration takes (e.g. the self-employed) could choose to pay themselves in shares rather than earned income (for example); the dividend income from these shares would then be tax-free. However, this could only be done up to the basic-rate tax limit.

In short, the Conservatives have produced a radical proposal that will help many smaller savers as well as reducing distortions to savings behaviour induced by the tax system. However, the overall distributional impact is regressive, and the proposal may open up new tax loopholes.

## 8.3 Extra help for pensioners

The Conservatives have two proposals that help many pensioners. On the tax side, they propose increasing personal income tax allowances for pensioners by £2,000. This reform is estimated to cost around £800m and would benefit pensioners whose income is currently more than £6,230 per year (those with lower incomes already pay no income tax and so would not see further gains). Estimates from Family Resources Survey data for 1998–99 suggest that the reform would benefit around 35% of pensioners. Pensioners falling into this category are mainly concentrated in the middle of the overall household income distribution. The maximum gain to a pensioner from the reform is

[4] J. Banks and S. Tanner, *Household Saving in the UK*, IFS, London, 1999.

£440 per year for a basic-rate taxpayer. Higher-rate taxpayers would not benefit because the extra personal allowance for pensioners compared with people of working age is tapered away for pensioners with £17,500 or more of income per annum.

At the same time, the Conservatives propose increasing the basic state pension by £1 per week for single pensioners aged 75 or over and by £2 per week for married couples aged 75 or over. These increases are over and above the increases that Labour plans for 2002 if re-elected. The cost of this reform is estimated to be around £100m. Analysis of the distributional effects shows that gains are concentrated in the bottom half of the income distribution, mainly because pensioners aged over 75 are a fairly poor group on average. However, the poorest pensioners are currently entitled to extra means-tested support through the minimum income guarantee (MIG); they are unlikely to gain, because MIG entitlement would be withdrawn pound-for-pound against any increase in pension income. However, the pension increase would help pensioners who did not realise they were entitled to the MIG or were not taking it up for some other reason.

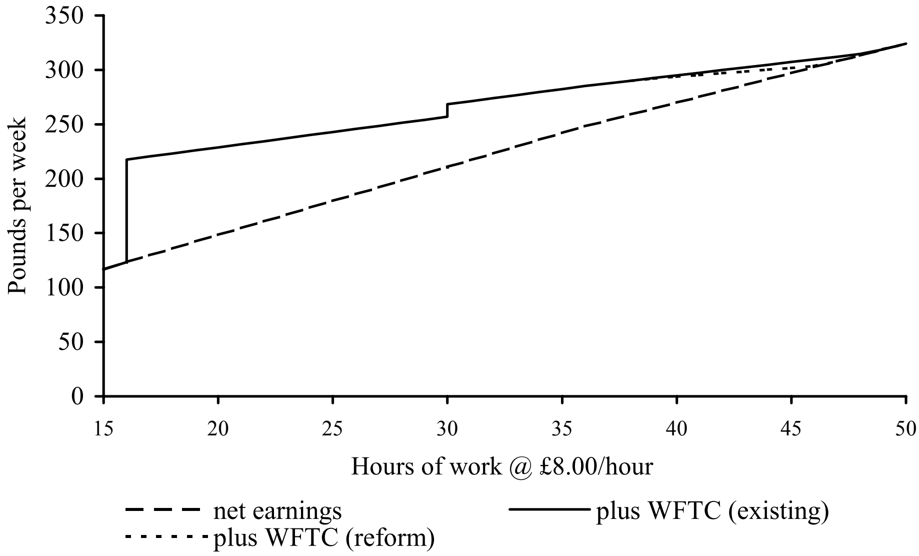
The third plank of Conservative proposals is the ‘consolidated pension’ – a plan to offer pensioners the option of waiving their entitlement to free TV licences for the over-75s, the winter fuel payment and the Christmas bonus in exchange for a higher basic state pension of equivalent value. At first blush, it is not clear why pensioners who pay income tax or those on the MIG would opt for consolidation, as the winter fuel payment and implicit value of the TV licence are not counted as taxable income or as income for the MIG means test, whereas an equivalent increase in the basic pension would be; these groups would therefore lose out from opting for pension consolidation, other things being equal. However, pensioners in specific groups not entitled to one or more of the specific payments being replaced (e.g. pensioners in nursing homes, who do not receive the winter fuel allowance) would gain from consolidation.

The Conservatives are considering changes to income tax coding and/or MIG rates for the affected groups to overcome the unattractiveness of opting for consolidation. However, these would significantly increase the administrative complexity of income tax and income support without making most pensioners any better off in real terms.

# 8.4 In-work benefit reform

The Conservatives plan to introduce a ‘kinked taper’ for the working families’ tax credit, which would reduce benefit entitlement for families whose entitlement is £30 or less under the current system. For these families, the WFTC withdrawal rate per pound of additional net income would rise from 55p to 70p. Figure 8.3 shows what the impact of this benefit cut would be on the budget constraint of a single parent with two children aged five and 11, working 16 or more hours per week with gross earnings of £8 per hour and no other income. The reform means that entitlement to WFTC disappears completely at gross earnings of around £375 per week, as opposed to £390 per week under the existing system, but its effect on the overall budget constraint is minimal. The reform is designed to save money as well as limiting the spread of high marginal rates up the income distribution, which the higher generosity and shallower taper of WFTC compared with its predecessor, family credit, have entailed. The reform would certainly be a step in this direction; however, set against this must be the impact of higher marginal deduction rates for those moved onto the 70% taper. The reform would also introduce additional complexity into the WFTC assessment for only modest gains to the exchequer: the savings from this reform are estimated to be roughly £75m.

**Figure 8.3. WFTC receipt by gross earnings under present system and with kinked taper**

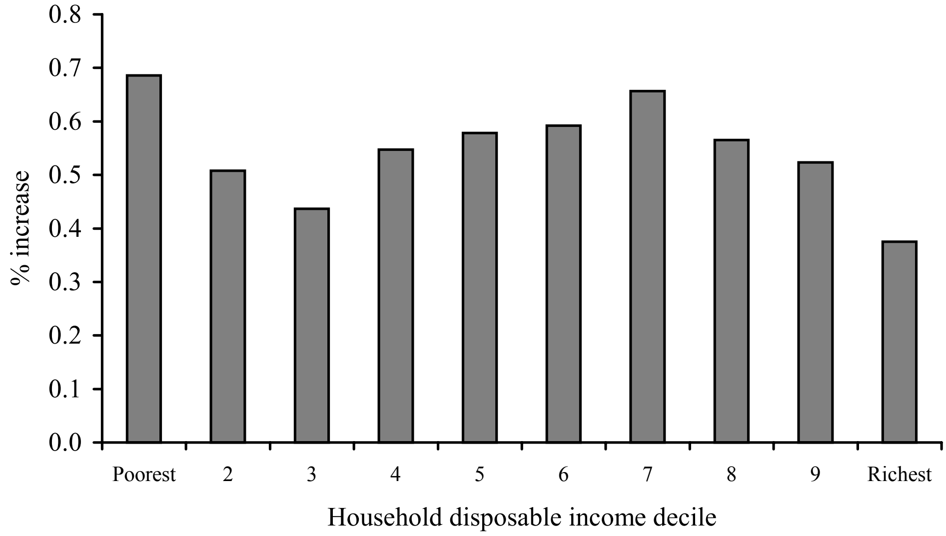



In addition, the Conservatives plan to make a further £200m of savings by scrapping the New Deal for Lone Parents (NDLP) and reducing the generosity of the Social Fund. As the NDLP is projected to cost around £100m in 2001–02, this implies that the Conservatives are planning to reduce the allocation of resources to the Social Fund by approximately £100m. The Social Fund currently provides loans for essential expenditure for families on income support or income-based jobseeker's allowance, as well as funeral payments, cold weather payments, winter fuel payments for pensioners and for families on income support, and community care grants. Government figures indicate that, in 1999–2000, total expenditure on the Social Fund was around £1.4bn. As a proportion of this, £100m seems small. However, the *discretionary* elements of the fund (community care grants, budgeting loans and crisis loans) amounted to only around £550m. If the Conservatives' £100m saving came exclusively from cuts in discretionary payments, this would substantially reduce the sum available to fund emergency payments to benefit claimants in difficult circumstances, making them worse off.

# 8.5 Cutting fuel duty

The Conservatives plan a 6p cut in duty on petrol and diesel. Figures from HM Treasury suggest that the cost of this reform will be in the region of £2.2bn.[5] Figure 8.4 shows the impact on the distribution of household incomes.

**Figure 8.4. The distributional impact of the Conservative fuel tax cut**




Source: IFS TAXBEN model, run on Family Expenditure Survey data for 1997–98.

The fuel duty cut has a slightly uneven impact on the distribution of household income, with the bottom decile gaining by most on average – just under 0.7% – but with all deciles except the richest gaining at least 0.4%. Of course, people who do not own or use a car will gain nothing from the reform, and as the proportion of car-owning households is higher for richer households than for poorer households, the *number* of gainers will be larger higher up the income distribution. Whilst the fuel protests of September 2000 seem to indicate that a cut in fuel duty would be a very popular policy with some fuel consumers, it should be recognised that reductions in petrol prices will presumably mean that car use and vehicle mileage will be higher than they would have been had duty remained at current levels. This could contribute to an increase in congestion and make reductions in carbon dioxide emissions harder to achieve.[6]

---

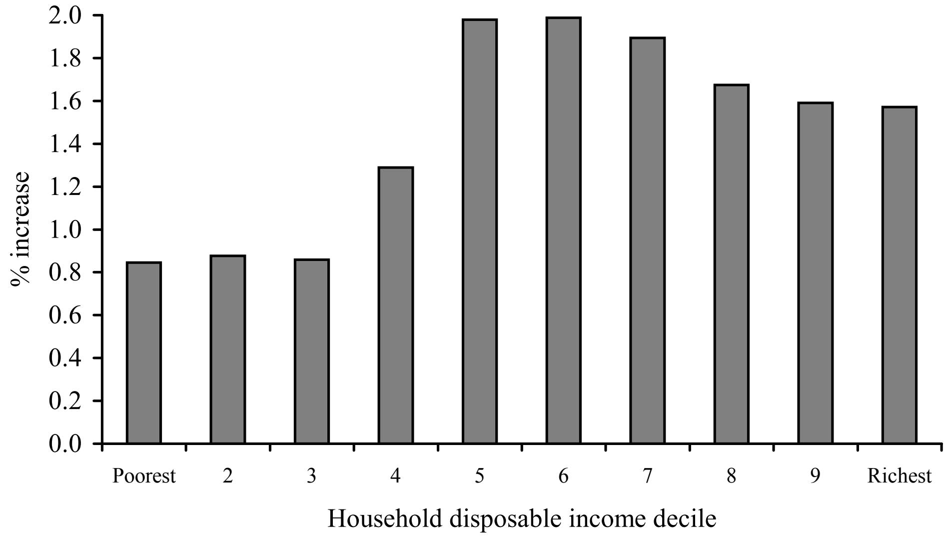
[5] Source: HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, London, November 2000.

[6] For a detailed treatment of these issues, see L. Blow and I. Crawford, *The Distributional Impact of Taxes on Private Motoring*, Commentary no. 65, IFS, London, 1997.

## 8.6 The overall effects of the reforms

This section shows what the combined net effect of all the Conservative proposals examined so far would be. Figure 8.5 shows the net effect of the Conservative package on the distribution of incomes in percentage terms by decile. When looking at this graph, it should be borne in mind that the Family Expenditure Survey data probably underestimate the impact of a few of the Conservative reforms (particularly the savings rate cut). None the less, the general shape of the results would be unlikely to change even if the data were more accurate.

**Figure 8.5. The effect of the Conservative package by income decile: percentage terms**




Source: IFS TAXBEN model, run on Family Expenditure Survey data for 1997–98.

Figure 8.5 shows that the distributional impact of the overall Conservative package is not straightforward. The clearest result is that the poorest 30% of households gain less on average than richer households. This is because most of the money being given away takes the form of various income tax cuts and reliefs, none of which can benefit the many households at the bottom of the distribution who pay no income tax. By contrast, the households in the middle 20% of the income distribution are the biggest gainers of all in percentage terms. Many households in this group gain from one or more of the transferable allowance, increases in pensioner tax allowances, the CTC increase for young children and the savings tax reforms. At the top of the distribution, the effect of the savings tax cut dominates. The cut in fuel duty is the one policy that has average benefits across all deciles.

In Figure 8.6, an analysis of how much people gain in terms of cash per week presents the same information in less abstract terms. On this measure, the richest 10% are way out in front. This is because a given percentage gain shows up as a larger cash gain for a rich household than for a poor household.

The cash analysis shows that the richer the decile, the larger is the average gain.

In Table 8.1, we present the average gains by family type. Families are presented in three sub-groups: families with children, pensioners and other groups. The table shows that single-earner couples with children do best from the Conservative proposals on average. This result is mainly driven by the transferable allowance for married couples with children under 11 and the increases in the children's tax credit for children under five. Two-earner couples where one of the couple has low earnings also gain from the transferable allowance plan. Pensioners do well on average, due to the increases in their income tax allowances, the savings tax cuts and the increases

**Figure 8.6. The effect of the Conservative package by income decile: cash per week**

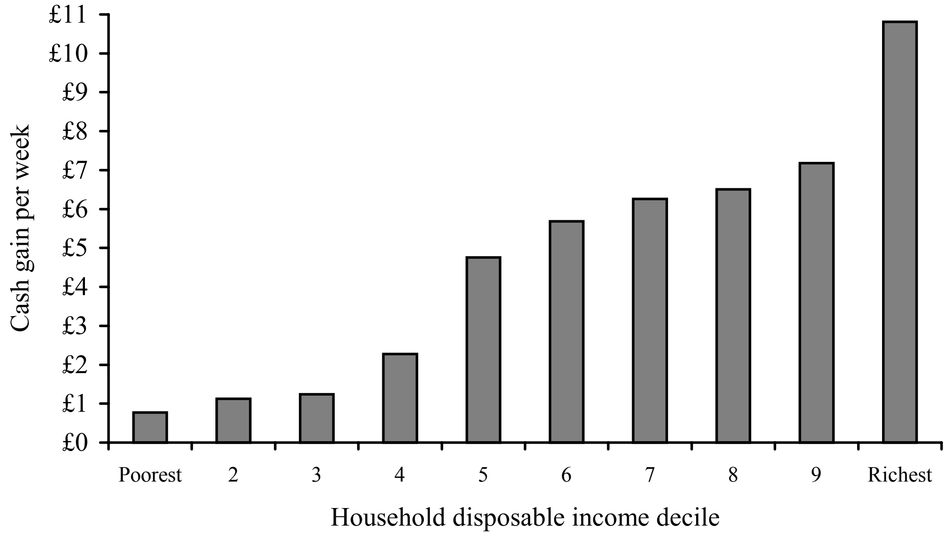



**Table 8.1. Average weekly gains from combined Conservative proposals by family type**

| Family type | Average weekly gain |
|---|---|
| *Families with children* | |
| Single-parent family | £1.12 |
| No-earner couple with children | £2.07 |
| Single-earner couple with children | £11.97 |
| Two-earner couple with children | £6.28 |
| *Pensioners* | |
| Single pensioner | £4.32 |
| Pensioner couple | £8.77 |
| *Others* | |
| Single, not employed | £1.89 |
| Single, employed | £2.45 |
| No-earner couple without children | £6.23 |
| Single-earner couple without children | £4.84 |
| Two-earner couple without children | £4.24 |

in the state pension for the over-75s. Couples without children all do fairly well on average from the reforms, with increases of between £4.24 and £6.23 per week. These gains are larger than anything seen for these groups under Labour since 1997 (as shown in Chapter 5), and show that the Conservative reforms would be less targeted on families with children than the last four years of tax and benefit changes. The large average gain for no-earner couples without children is principally driven by the people in this group who have retired early with high levels of savings, and hence gain strongly from the abolition of savings tax for basic-rate taxpayers. The groups gaining least from the Conservative package are single non-pensioners of all types.

# 8.7 Additional Conservative tax proposals

A range of additional Conservative tax proposals go beyond the scope of the analysis undertaken in this chapter, principally because paucity of data means we are not able to identify with precision the gainers and losers from them. The firm additional tax-cutting commitments comprise: further tax relief on approved share options; simplification and reduction of capital gains tax; repeal of the IR35 legislation; and reduced business rates in rural areas. The Conservatives are also committed to abolition of the climate change levy, funded by a 0.5% increase in employer National Insurance contributions.

# 8.8 Conservative long-term aspirations

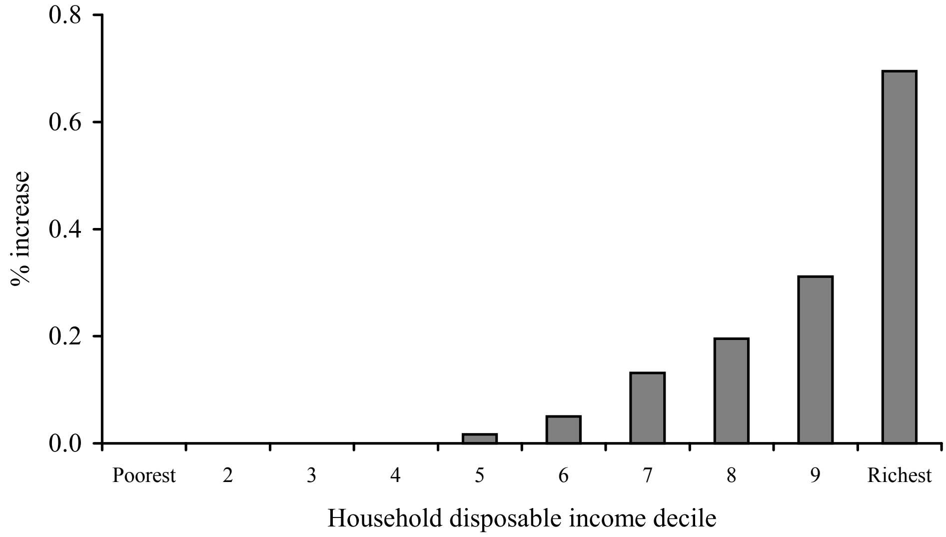
## Raising the higher-rate threshold of income tax

Shadow Chancellor Michael Portillo has said that, over the course of a parliament, as and when funds allow, the Tories would like to raise the higher-rate threshold (HRT) of income tax by around £2,500. It is currently set at £29,400 of taxable income. The motivation behind this policy is that the number of higher-rate taxpayers has increased from around 2 million in 1996–97 (the last year of the Conservative administration) to more than 2.7 million in 2000–01. Given the current earnings distribution, a rise of £2,500 in the HRT would remove around 500,000 people from the 40% rate.

The distributional effects of this increase in the HRT are shown by income decile in Figure 8.7. The beneficiaries from the reform are individuals whose income is currently above the HRT. Not surprisingly, they are concentrated at the top of the income distribution. The maximum gain – to someone earning at least £2,500 more than the HRT – would be around £8.65 per week.

The number of higher-rate taxpayers tends to increase over time because tax thresholds are habitually indexed by price inflation from year to year whereas earnings normally grow by more than price inflation – a process known as ‘fiscal drag’. The Conservative proposal is designed to compensate for fiscal drag. However, if the reform were to be enacted later rather than sooner in a Conservative parliament, one would expect that fiscal drag that is likely to occur *after* 2001 would increase the number of higher-rate taxpayers still further – thus making it more expensive to restore the 1996–97 position fully.

**Figure 8.7. Distributional effects of increasing the higher-rate threshold by £2,500**




### Tax breaks for private medical insurance

The Conservatives plan tax reductions and cuts in National Insurance contributions for individuals who take out private medical insurance (PMI). One argument for this reform is that it may reduce pressure on NHS resources by increasing the incentives for people to use alternative private sector care. However, as shown in a recent IFS study,[7] the current distributional incidence of PMI is strongly skewed towards the top of the income distribution. Whilst this does not rule out the possibility that a tax break might encourage PMI further down the income distribution, it should be borne in mind that the Conservative proposal has a large dead-weight cost attached to it because the tax break subsidises PMI for individuals who *already* hold it as well as encouraging new take-up of PMI. In addition, it is likely that increased coverage of PMI would reduce the overall level of support for increased spending on the health service, as suggested by existing research into support for the NHS among people with private health insurance.[8]

## 8.9 Conclusions on Conservative tax and benefit proposals

So far, this chapter has analysed the Conservatives' tax and benefit proposals. We have seen that their proposed tax cuts for families with children help

[7] See Figure 5.5 in C. Emmerson, C. Frayne and A. Goodman, *Pressures in UK Healthcare: Challenges for the NHS*, Commentary no. 81, IFS, London, 2000.

[8] T. Besley, J. Hall and I. Preston, *Private Health Insurance and the State of the NHS*, Commentary no. 52, IFS, London, 1996.

middle-income households most. Meanwhile, the abolition of basic-rate savings tax has a regressive distributional impact. The 6p cut in fuel duty has a fairly even distributional impact but helps car-owning households in the lowest 10% of the income distribution most. Combined with tax cuts for pensioners, the pension increases and modest cuts in the working families' tax credit, the overall effect of the Conservatives' plans is to help families in the middle and at the top of the income distribution more than the poorest 30%, largely because of the focus on reduced income tax. But families in all income deciles see average gains of at least 0.8% in their disposable incomes. The biggest average gainers by family type are single-earner couples with children.

The Conservatives estimate that the net cost of their tax cut package will be around £8bn. The remainder of this chapter assesses their plans to cut spending by £8bn to pay for these tax reductions.

# 8.10 Can the Conservatives cut spending by £8bn?

The Conservatives plan to spend £8bn less than the current published government plans. This is a relatively minor proportion of government expenditure – a little less than 2%. But the Party is committed to match Labour funding in a number fields – notably health, education, the police, defence and transport. This section asks whether the Tories have credible plans to save money in other areas of government spending.

Table 8.2 lists the proposed spending cuts relative to Labour's plans.

### Reductions in state activity

There is no question that some of the cuts represent genuine reduction in the scope of state activity, and should therefore be expected to yield savings. For example, the list of Department of Trade and Industry activities earmarked for cuts would involve the government doing less and so spending less. The same is true of the proposed reduction in the regeneration budget; in this case, the Conservatives propose to substitute tax cuts of a similar magnitude to encourage the private sector to substitute for the regeneration activity from which the state would be withdrawing.

Likewise, some of the social security measures represent a straightforward reduction in the generosity of the benefit system through a tightening of conditionality. Forcing lone parents whose youngest child is 11 or older to get jobs, rather than rely on income support, is one example, while the 'Can Work, Must Work' guarantee (a dilution of the entitlement of unemployed people to reject job offers regarded as unsuitable) is another.

In some of these cases, dispute about the precise saving to be obtained may remain; for example, the cash saved by forcing lone parents of older children to seek work will depend on the availability of jobs. But still, in these cases, there is little doubt that the Conservatives are proposing to move public policy in a direction that should save some public money by reducing either state activity or the generosity of state transfers. They therefore represent a genuine alternative to Labour on the appropriate balance between tax and public spending.

**Table 8.2. Conservatives' proposed reductions in spending (£m)**

| | 2003–04 |
|---|---|
| **Spending on bureaucracy** | **1,800** |
| | |
| *Social security spending* | |
| Fraud package | 1,000 |
| Can Work, Must Work guarantee | 330 |
| Disability fundholding | 100 |
| Privatising industrial injuries benefit | 160 |
| Requiring lone parents with children aged 11 or over to seek work | 500 |
| Reform of housing benefit | 425 |
| **Total social security** | **2,500** |
| | |
| *Department of the Environment, Transport and the Regions (DETR)* | |
| Scrapping 'best value' | 125 |
| Not implementing the full roll-out of arm's length companies | 100 |
| Savings on housing PFI | 200 |
| Not creating regional assemblies | 205 |
| Interest from sale of QE2 Centre, Ordnance Survey and 2 Marsham St. | 25 |
| Streamlining GORs, abolishing RDAs, streamlining Planning Inspectorate | 100 |
| Regeneration | 200 |
| **Total Department of the Environment, Transport and the Regions** | **1,000** |
| | |
| *Department of Trade and Industry* | |
| E-commerce subsidies | 20 |
| State as venture capitalist | 50 |
| 'Local competitiveness budget' | 100 |
| 'Innovation budget' | 40 |
| Regional expenditure | 25 |
| Advertising export services | 30 |
| University Challenge and Reach Out Fund | 20 |
| **Total Department of Trade and Industry** | **300** |
| | |
| **Replacing the New Deal with Britain Works** | **400** |
| | |
| **Creation of a community legal aid fund** | **500** |
| | |
| **Endowing universities** | **1,300** |
| | |
| **Endowing Britain's culture** | **200** |
| | |
| **GRAND TOTAL** | **7,955** |

Source: Conservative Party website, www.conservatives.com/issuestax3.cfm.

## Savings that aim to avoid a reduction in state service provision

A very large proportion of the savings presented, however, would supposedly see government outlays fall without a reduction in the quality or quantity of public provision. The two most important examples are the proposed saving on government administration and the social security fraud package. Together, these two measures alone represent 35% of the total proposed savings. The difficulty here is that it seems likely that any government that could costlessly save in this way would do so, making it doubtful that these can be claimed as specifically Conservative savings.

The proposed saving on administration is set at £1.8bn because 'Labour have allowed the cost of Government administration to rise by £1.8 billion in cash terms since the election'.[9] This seems arbitrary – much of the cash increase since that year simply compensates for inflation, and the inflation rate over the last four years does not obviously relate to the optimal amount of real resources to spend on administering government. It also implies that the Conservatives believe that they can now run government with less real resources than they required when they were last in office.

If there were a determination to cut administration costs by this amount regardless of the consequences, then the risk arises that this would adversely affect either the efficiency or the delivery of public services. If, on the other hand, the cuts were conditional on there being no adverse side-effects, it might be impossible to deliver them on this scale. Opposition parties often find it attractive to suggest that savings can be made on 'red tape' – Labour in 1997 argued that such savings would fund its NHS waiting-list initiative. In government, achieving such savings proves less easy. From very early in its term, Labour found it necessary to divert additional resources to the NHS rather than simply to redirect cash from management to front-line services.

Savings on fraud are similarly easier to assert than to achieve. It might be possible to reduce fraudulent claims by an increase in the policing of the conditions of benefit claimants, but such an initiative might impose hassle and delays in payment on genuine benefit claimants who would, presumably, be required to spend more effort proving that they were entitled than is currently the case. If fraud could be cut without such adverse side-effects, it is unclear why any government would choose to put up with it.

Various other measures in the list also seek to secure lower spending without a reduction in service provision. For example, the proposal to administer legal aid through a community fund could certainly save money if the move involved a cut in legal aid funding. If it did not, it is less obvious it would succeed. Likewise, the claim that the housing budget could be cut without reducing the quality of the social-rented stock needs to be argued rather than asserted. It might also be seen as optimistic accounting to claim £205m from not setting up regional assemblies when there is, it seems, no provision for these in the current public finance plans. The assertion that a privatised New Deal programme would be £400m cheaper without being less effective is another example of a strong assertion backed by little evidence.

---

[9] *Conservative Spending Plans: Saving Money, Improving Vital Services, Room for Tax Cuts*, The Conservative Party, London, 2001.

## Endowing universities and Britain's culture

The final set of proposals concern the creation of endowment funds that would provide certain institutions with a stream of income that would substitute for government spending. The most important example is the creation of an endowment for universities from capital realised by the annual sale of the student loan book. On close inspection, the policy turns out to have two elements.

The first is the restructuring of student loans, which would, most significantly, involve interest being calculated at the market interest rate instead of the current subsidised interest rate. The Conservatives believe that this would raise £700m per year. This represents a genuine political choice to withdraw an element of state subsidy, seemingly making a legitimate part of the £8bn of cuts offered.

But the Conservatives plan to couple this with a pre-commitment to more generous tax treatment of graduates, from 2005–06, when they come to repay their loans. As the funds from the subsidy cut will already have been 'spent' on part of the initial £8bn of tax cuts the Conservatives plan to make, this future commitment implies a modest weakening of the public finances, as it means forgoing a certain amount of future income tax revenue. It is not obvious that the Conservatives have any special means to address this weakening that would not be available to alternative administrations.

The second element of the policy sees the revenue from the sale of the loan book invested in the private capital markets, rather than being used to pay off national debt, which it is implicitly assumed is what alternative governments would use the revenue to do. The income derived in this way would be given to universities, and government funding would be cut commensurately. But the Conservatives assert that they could, on the basis of historical experience, reasonably expect that the privately invested assets would yield a 2% excess return compared with what would effectively be achieved by a policy of reducing national debt, enabling them to cut university funding by more than they would have saved by reducing public debt.

As the loan book is sold annually, the Conservatives assume that, every year, by investing in stocks, they could effectively obtain a new stream of income worth 2% of the loan book in perpetuity. Because a new income stream is obtained annually in this manner, the Conservatives argue that they can claim the total present value of this future income stream as a saving in every year. If the overall merit of the scheme is granted, capitalising the stream of savings in this way would seem justifiable on economic grounds, even though it implies a higher level of borrowing. The annual sell-off means that, over time, the universities would see an ever-larger part of their income deriving from endowments rather than direct grants.

A number of objections might be made against the policy of endowing universities as opposed to continuing with traditional state subsidy. First, the 'excess return' supposedly earned by investing in equities as opposed to debt should in fact – if financial markets work efficiently – reflect the higher risk associated with these assets. If the government is averse to taking on risk, then the gains from investing in stocks come at a cost that must be faced.

Second, if the government decided that the state's taking on some risk in this way would be beneficial, there is no reason why the optimal extent of this risk-bearing should be equal to the scale of the loan sell-off. In theory, the national debt could be doubled and all of the money invested in stocks, yielding a massive exchequer benefit.

Finally, it seems unappealing that, when the state absorbs risk in this way, it should be borne exclusively by one element of the public sector – the universities. For if the government is taking on risk, it might be expected that it would be better that this risk were spread across spending activities, so that the fluctuation in income for any individual part of the public sector is reduced. Over time, if, as the Conservatives plan, universities are increasingly to be funded by endowment, then eventually a large proportion of their income would be subject to the volatility of stock markets. In these circumstances, given their need to budget to provide certain services every year, it might well be that they would prefer an investment in something such as government debt, which yields a lower average return but greater certainty of income.

# 8.11 Conclusions on Conservative spending proposals

Some of the Conservatives' proposed cuts involve the state withdrawing from certain activities – for example, supporting certain groups through social security and subsidising certain business activities. But these represent only a small portion of the total of £8bn. Where the claim is that the remaining cuts are without consequence for public provision, the best assumption is that alternative administrations would deliver the same; where there are such consequences, which other parties may shrink from, then an open debate about these would be welcome.

While in the short term the Conservatives could end up funding part of their £8bn tax cut through increased borrowing without particularly serious consequences for the public finances, in the longer term a desire to reduce taxes must, if it is to be achieved, be matched by a willingness to identify reductions in the scale of public services.

*Tom Clark and Howard Reed*

# 9. The Liberal Democrat proposals

As we saw in Chapter 7, the Liberal Democrats wish to increase both tax and public spending by around £8bn annually relative to government plans. The average financial effect on households would be negative, as higher taxes would largely be used to direct revenue from households towards public services, such as health and education. But even in financial terms, some households would gain, because part of the proposed public spending increase would be on benefits, such as the retirement pension.

This chapter asks which families would gain and which would lose from Liberal plans for the tax–benefit system, but first it outlines and analyses the specific measures.

## 9.1 Tax-raising measures

Table 9.1 lists the Liberal Democrats' proposed tax increases and shows how much each raises. More than £6bn of the total of almost £8bn comes from higher income tax. This derives from two measures which yield similar amounts – a one penny increase in the basic rate, to 23p in the pound, and a new 50% higher rate of tax to be charged on gross income above £100,000. The rest of the revenue is raised through capital gains tax reforms.

**Table 9.1. Revenue effects of proposed tax changes**

| Measure | Annual exchequer yield |
|---|---|
| *Income tax* | |
| Increase basic rate from 22% to 23% | £2,800m[a] |
| 50% rate on income over £100,000 | £3,400m[b] |
| | |
| *Capital gains tax* | |
| Reversal of Labour 'taper' reforms | £400m[c] |
| Exemption at death removed | £1,100m[a] |
| | |
| Total | £7,700m |

Notes: Estimates are in 2001 prices and are on an accruals basis, i.e. full-year effect is shown. Estimates for yield from basic-rate increase are based on 1999–2000 income tax system. The IFS tax and benefit model, TAXBEN, run on 1997–98 Family Expenditure Survey data, suggests yield would be around 3% lower under 2001–02 system. Exchequer yield from reversing Labour's capital gains tax reforms is net of revenue forgone in reintroducing indexation and retirement relief.
Sources:
a. HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, London, November 2000.
b. Parliamentary Question no. 148940, answered on 14 February 2001.
c. Parliamentary Question no. 153714, answered on 14 March 2001.

### Income tax proposals

The extra penny paid on each pound taxed at the basic rate would only affect people with gross income above £6,415. Those with gross income above

£33,935 face the maximum tax rise of £275 each year, or £5.30 extra each week. For people with income between £6,415 and £33,935, gains depend positively on income.[1]

The new 50% band represents a 10 percentage point increase on the current 40% top income tax rate. It would only affect individuals with a gross income above £100,000 and would only apply to the top tranche of income. Such individuals would forgo an extra 10% of income possessed in excess of £100,000. The policy would affect only 300,000 people, or, roughly, the richest 1% of taxpayers.[2] Very high-income individuals would see a quite substantial increase in tax liability. Someone with an annual income of £300,000, for example, would pay £385 extra in tax each week.

Together, these reforms represent a modest reversal of the trend for cutting income tax rates that has been a prominent feature of fiscal policy for the past 25 years.

## Capital gains tax proposals

Capital gains tax (CGT) is a levy on the benefit individuals receive when they buy an asset at one price and sell it on at a higher price. Gains made from selling one's principal home are exempt, leaving stocks and shares as the main type of asset affected. There is also a substantial tax-free allowance on capital gains, worth £7,500 each year. At present, CGT is a small tax, yielding around £2bn each year for the Treasury.[3] The Liberal Democrats propose to increase its take by £1.5bn through two reforms.

The first set of proposed changes is reversal of the CGT reforms undertaken by the current government, which were briefly outlined in Chapter 5. The reduced rates that now apply to assets held for long periods would be abolished, and indexation, which exempted gains that merely compensated for inflation, would be reintroduced. Further, Labour's preferential treatment of 'business assets' would also be ended, although business owners would be partially compensated for this by the reintroduction of 'retirement relief', which ensured individuals over 50 could receive the first £250,000 of capital gains from selling the family business tax-free, with the next £750,000 being taxed at half the standard rate. Taken together, these reforms would raise £400m annually.

Reversal of Labour's reform would have the merit of simplifying the tax system: the large number of rates at which CGT was charged would be reduced. It would also be a step towards aligning the tax treatment of income and capital gains, as the latter would typically be taxed at one's marginal income tax rate. This would reduce the likelihood that the CGT system would

[1] Illustrative figures are for a single childless person who is under 65 years of age.

[2] Source: *Inland Revenue Statistics*, 2000. Latest updated edition available from http://www.inlandrevenue.gov.uk. The figure is based on projections of the 2001–02 income distribution.

[3] Source: *Inland Revenue Statistics*, 2000. Figure is for 1998–99, the most recent year for which an estimate of yield is available.

distort people's behaviour by encouraging them to convert income into capital gains in order to reduce their total tax liability.

The second element of the Liberals' proposal to increase CGT is to abolish the exemption for capital gains unrealised at death, which has existed since 1971. This could raise £1.1bn per year, although the yield might be reduced if individuals altered their behaviour to avoid their estate paying CGT after their death. As well as raising money, the reform could be advanced on the grounds that it would ameliorate the distortion that the current system imposes against disposing of one's assets before death for people planning their bequest.

Removing the exemption might be objected to on the grounds that the total tax rate on some estates would be left very high, as both inheritance tax and CGT could be charged simultaneously. Inheritance tax is paid at 40% on the top tranche of estates worth £242,000 or more; CGT would apply in addition to this on any part of the estate that represented capital gain in excess of £7,500. This 'double taxation' would mean that tax could consume very large proportions of some parts of the estate, although it should be stressed that the generous thresholds in both CGT and inheritance tax, together with the fact that estates will only ever partially consist of capital gains, would help contain the total effective tax rate applied to estates.

Data limitations mean we cannot model the precise incidence of this tax increase, but we argued in Chapter 5 that there are strong reasons to think that Labour's CGT reforms could be characterised as a substantial tax cut for a small group of people who are, for the most part, relatively well off. Reversing these measures is a substantial tax increase for this same group. Ending the CGT exemption on gains that remain unsold at death would tend to hit the estates of the wealthiest individuals hardest. Both elements of the Liberals' CGT proposal can thus be characterised as broadly progressive tax increases.

## 9.2 Benefit increases

### Pensions

The Liberal Democrats would increase the basic state pension by £5 per week for pensioners entitled in their own right, and increase the couple rate by £8. This is over and above the increases that Labour is planning. In addition, they would introduce new age-related additions, which would be received in full regardless of any incompleteness in National Insurance contributions records. Every pensioner aged 75 to 79, regardless of whether they claim in their own right or in respect of their partner's National Insurance contributions, would

**Table 9.2. Weekly basic state pension increases under Lib Dem plans**

| Age | Single | Couple |
|---|---|---|
| Retirement age to 74 | £5 | £8 |
| 75 to 79 | £10 | £18 |
| 80+ | £15 | £28 |

Note: Figures for couples assume that one partner receives the dependant's addition in respect of their spouse's National Insurance contribution record and that both partners fall within the same age bracket.

receive an extra £5, and every pensioner aged 80 or over would receive an extra £10. Table 9.2 shows the total effect on the basic pension received by singles and couples of different ages.

The cost of the proposed increases would be substantial, at around £2.8bn per year.[4] The policy would represent a very decisive shift from the approach of the current government, which has targeted much of the extra support made available for pensioners through increased means-tested benefits rather than by increasing the state pension, which is received by rich and poor alike. Indeed, the Liberal Democrats are advancing the policy as an explicit alternative to Labour's reliance on means testing. The more generous treatment of older pensioners, who tend to be poorer, is supposed to be a way of targeting help without relying on an explicit income test.

But the intention to move away from a means-tested system has led the Liberal Democrats to avoid coupling the pension increase to any proposed increase in the means-tested minimum income guarantee (MIG). Consequently, MIG recipients would see their increased state pension cancelled out by lower MIG entitlement. As a result, the Lib Dems could be criticised for failing to provide any increase in benefit entitlement for the poorest pensioners. But against this charge must be weighed the consideration that the very poorest pensioners of all are those who do have MIG entitlement but do not claim it, and these people would be helped by the Liberal policy.

The differing attitudes of the parties to means-testing more generally are considered in Chapter 11.

## Families with children in long-term poverty

The Liberal Democrats propose to award £3.85 per week to families with children who have been in receipt of income support for more than one year. The extra help is designed to alleviate the specific problems associated with long-term poverty. Around a million families could gain, at an annual cost of around £200m.

## Measures for the young

The Liberal Democrats plan to extend entitlement to income support and housing benefit to people aged 16 or 17 who have already left full-time education. This policy would cost about £100m each year.[5] Currently, people under 18 can only claim support in special circumstances (e.g. after leaving young offenders' institution). Another proposal in the area of means-tested support would be the relaxation of the single-room rent restriction applicable to housing benefit claimants under 25. This would allow young people who do not share accommodation to receive full housing benefit support, at an annual cost of £30m.[6]

---

[4] Parliamentary Question no. 140950, answered on 30 November 2000.

[5] Parliamentary Question no. 110061, answered on 17 February 2000.

[6] Estimate from Shelter's Policy Unit Briefing Note, May 2000.

Young people on low earnings would also benefit from the Liberal Democrat policy of increasing the 'youth' rate of the minimum wage to the adult level for all aged 16 or over. At present, the minimum wage for people aged 18 to 21 inclusive is £3.20, as against £3.70 for workers of 22 or above. There is currently no minimum wage for workers of 16 or 17. The distributional effects of the proposed change to the minimum wage are excluded from the rest of the analysis in this chapter.

### Winter fuel payments for disabled people

The Labour government has introduced and increased winter fuel payments for the over-60s, which on current plans will pay out £150 each year.[7] The Liberal Democrats argue that these should be extended to people under 60 with severe disability, defined as those who qualify for the health-contingent disability living allowance at higher rates.[8] The policy should benefit around 1.5 million households at an annual cost of a little over £200m.

While redistributing money to the severely disabled may be a worthy aim, it is not obvious that this policy is the best way to deliver it: increases in the rates of disability living allowance itself would achieve the same without the administrative complication.

### Cold weather payments

The Liberal Democrats also propose to include the wind-chill factor in assessment of the cold weather payments made through the means-tested benefit system. This measure would cost just £8m a year and would not effect a significant redistribution of income.

## 9.3 Distributional effect

We model the Liberal tax and benefit changes as decreasing household incomes by around £2bn per year, about £1.60 per week for every household. Two factors mean that the negative effect of Lib Dem reforms on household incomes will be underestimated. First of all, as already mentioned, we cannot model the capital gains tax reforms which would reduce household incomes by about £1.5bn. Second, the Family Resources Survey (FRS), on which the simulations have been run, undersamples the very richest households, which would see large increases in their tax bills following the introduction of the 50% band. Thus, even though we can model the reform, our results are likely to underestimate its effect. Sections 9.1 and 9.2 showed that, while the Liberal Democrats would increase taxes by £7.7bn, increases in direct benefits would amount to about £3.3bn. The £4.4bn difference between these suggests an average loss of around £3.60 per week per household, which is a more accurate estimate of the average change.

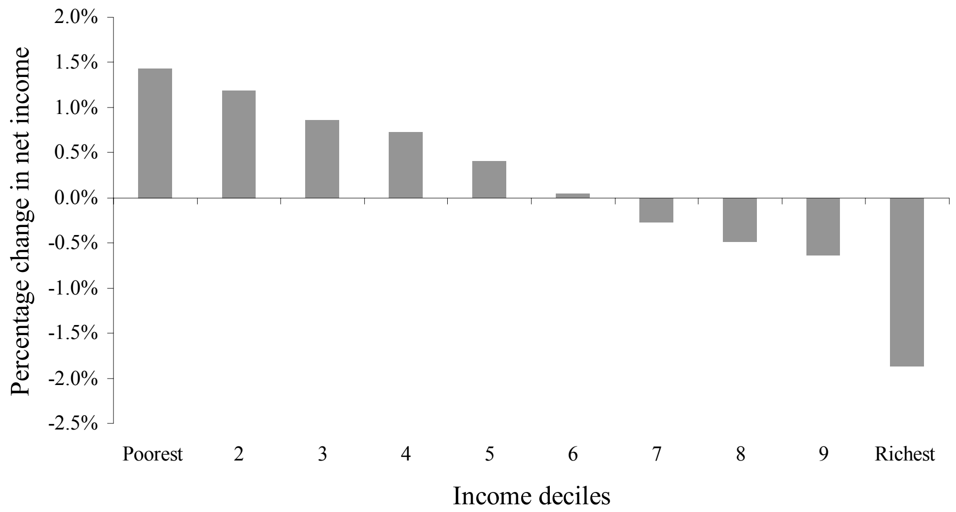
---

[7] The 2000 Pre-Budget Report increased the payment to £200, but only for the single year 2000–01.

[8] Including the medium rate of the care component.

Figure 9.1 illustrates the effect of the Liberals' proposed changes in direct taxes and benefits on average post-tax incomes in each income decile. Modelled reforms exclude the capital gains tax proposals and abolition of rent restrictions for under-18s. The impact of the two income tax reforms explains a large part of the progressiveness of the package. The 50% tax rate is clearly a tax rise exclusively for the rich. Losses from the increase in the basic rate of tax are restricted to those with income sufficient to pay basic-rate tax: for childless individuals under 65, this is gross annual income above £6,415. Losses vary positively with income until the higher-rate threshold of £33,935 per year, above which a flat-rate loss is incurred.

**Figure 9.1. Distributional effect of Lib Dem tax and benefit reforms**




Notes: The FRS has been used here as it offers the best available data on incomes. By contrast, analysis of the other parties' proposals has been based on Family Expenditure Survey data because, unlike the Liberal Democrats', they affect the levels of indirect taxes, which means data on family expenditure are required, something the FRS does not contain. Income deciles are derived by dividing the population into 10 equally sized groups according to household income adjusted for family size. Decile 1 contains the poorest tenth of the population, decile 2 the second poorest and so on, up to decile 10, which contains the richest tenth.
Source: The IFS tax and benefit model, TAXBEN, run on 1998–99 Family Resources Survey.

Households in the bottom decile gain most, both in absolute and in proportional terms. This largely reflects the extension of means-tested support to under-18s. The average gain to a household in the bottom 10% of the income distribution is about £2.20 per week. This figure is likely to be an underestimate since it is based on the assumption that the poorest pensioners take up their means-tested benefit entitlement, which would prevent them gaining from the proposed basic pension increases. In practice, the very poorest pensioners are likely to be those who fail to take up this means-tested support, and individuals in these circumstances would gain from the higher state pension. Increases in the retirement pension are the most important reason why, on average, households in all other income deciles below the seventh gain from Liberal proposals. By contrast, the top 40% of the income distribution see their incomes fall as a result of the reforms, as income tax increases outweigh benefit increases.

The richest 10% are modelled to lose £17.60 per week. The figure is likely to underestimate the effect of the income tax reform, because of the undersampling of rich households. The simulated yield from the proposed 50% tax band is about £1.5bn, which underestimates the true yield by about £1.9bn. This £1.9bn in extra tax would certainly fall entirely on the richest 10% of the population, making their total average cash loss £32.90 per week. Overall, therefore, the top 10% would see their disposable incomes fall, on average, by 3.5%. But even within the top 10%, the effect is highly uneven. Among households in the top decile, the great majority would see their disposable incomes rise slightly or fall by less than £10 per week; for the remainder – chiefly households containing the highest-income individuals – the cash loss would be substantial.

Table 9.3 shows average weekly gains and losses by family type following the introduction of the Lib Dem package. Income tax rises mean that most family types lose on average. Pensioners stand out as the exception. A single pensioner would gain just less than £3 per week on average, while pensioner couples would benefit by about twice as much. Despite the fact that reforms would increase universal benefits, the average gains are lower than the proposed increases. This is because neither taxpaying pensioners nor those on means-tested benefits would see their disposable incomes rise by the full amount of the pension increase.

**Table 9.3. Average weekly gains from Lib Dem proposals by family type**

| Family type | Average weekly gain |
|---|---|
| *Families with children* | |
| Single-parent family | £0 |
| No-earner couple with children | £1.77 |
| Single-earner couple with children | –£7.98 |
| Two-earner couple with children | –£4.83 |
| *Pensioners* | |
| Single pensioner | £2.96 |
| Pensioner couple | £5.89 |
| *Others* | |
| Single, not employed | £0.71 |
| Single, employed | –£4.18 |
| No-earner couple without children | £0.34 |
| Single-earner couple without children | –£3.80 |
| Two-earner couple without children | –£5.77 |

# 9.4 Longer-term aspirations

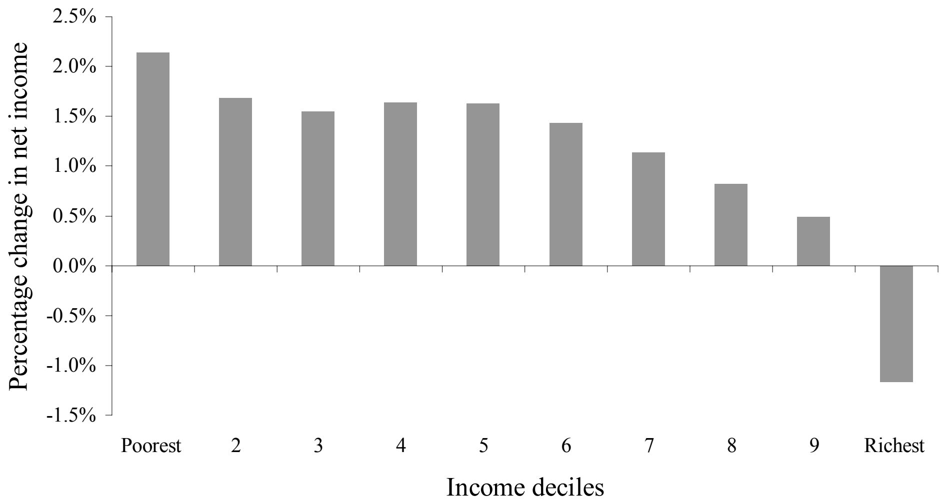
In addition to the definite commitments that we have analysed in the paragraphs above, the Liberal Democrats have announced an aspiration to abolish the 10% starting rate of income tax when this is affordable. This is equivalent to extending the personal allowances by £1,880 per year. It would be a significant break with the policy of the present government, which replaced the 20% lower rate with a new 10% starting rate. The abolition of the

10% band would benefit anyone with gross income in excess of £4,535.[9] The largest amount that any individual could gain from the reform is £188 per year (just over £3.60 per week). This gain would go to anyone with income above the level at which basic-rate tax begins, which is £6,415.

This reform would make the income tax system administratively simpler, reducing the number of tax bands by one and removing around 2.69 million individuals (almost 10% of taxpayers) from the tax net. This would see the exchequer forgoing £4.5 billion per annum in income tax revenue.[10] The extent of this simplification would be somewhat reduced if the National Insurance (NI) system were not reformed at the same time. Reforms to NI during the last Parliament saw the lower earnings limit (LEL) aligned with the income level at which individuals begin to pay income tax. Abolition of the 10% rate without a corresponding change in the LEL would reintroduce the discrepancy that has recently been eliminated. But if the LEL were raised commensurately, the cost of the reform would rise very substantially.[11]

In the long run, the Liberal Democrats also propose to increase income support and housing benefit levels for those under 25 to the levels applicable to people aged 25 and over. The reform would raise the level of these benefits to £53.05 for single people and £83.25 for couples from the current levels of £42.00 for single people under 25 and £63.35 for couples under 18.

**Figure 9.2. Distributional effect of Lib Dem tax and benefit reforms, including 'aspirations'**




Note: See notes to Figure 9.1.
Source: The IFS tax and benefit model, TAXBEN, run on 1998–99 Family Resources Survey.

---

[9] This is the level of the personal tax allowance on earned income for single adults under 65 in the 2001–02 tax system. There are higher allowances for older people.

[10] Source: TAXBEN run on 1998–99 FRS data.

[11] Abolition of the 10% rate with corresponding increases in the LEL would cost £11.5bn a year. This figure includes the costs of raising the LEL in employee, self-employed and employer NI contributions to £123.40 per week.

Both of these measures would benefit households at the lower end of the income distribution. This is clearly shown in Figure 9.2, which demonstrates the distributional effect of the Lib Dem package including longer-term measures. Given that the highest gains from abolition of the 10% tax rate would go to households with multiple basic- or higher-rate taxpayers, adding this measure reduces the progressiveness of the Liberal Democrat package.

Families in the bottom decile now see their disposable incomes rise by £3.30 per week on average. All other deciles see their incomes rise primarily because of the abolition of the 10% tax rate. This policy benefits all those earning more than £4,535 per annum and, combined with state pension increases (on average), is enough to outweigh the effect of the income tax increases described above in all but the top income decile.

# 9.5 Conclusions

The Liberal Democrats propose to increase personal taxes in order to increase expenditure on what they see to be priority issues. Some of the increases in spending represent a handing-back of disposable income through the benefit system. The overall effect of the changes in direct taxes and benefits would be progressive, with gains near the bottom of the income distribution and losses at the top. A proposal to abolish the 10% tax rate would make the package somewhat less progressive. This policy and some of the other proposals analysed here – notably those for the pension system – would represent a significant change in direction compared with the policy of the incumbent government.

*Tom Clark, Michal Myck and Matthew Wakefield*

# 10. Labour's proposals

Chapter 5 showed how households have been affected by Labour's tax and benefit reforms. This chapter discusses further tax–benefit reform that Labour proposes to introduce if re-elected. The first section discusses three 'credits' the government is proposing to introduce – the integrated child credit, the pension credit and the employment tax credit. We analyse their likely effect on household incomes and how much each would cost to introduce.

The new credits represent developments of tax–benefit reforms implemented in the last Parliament, but Labour's manifesto also contains proposals for 'asset-based' welfare, which would represent more of a new departure. In particular, the party plans to introduce two new policies – the Child Trust Fund and the Saving Gateway. Both are targeted towards low-income households and provide financial assistance in the form of assets. This method of asset-based welfare delivery contrasts with (and is intended to complement) the traditional approach of providing social security benefits as income supplements. Section 10.2 considers some of the arguments for and against the proposed new approach.

Finally, we consider Labour's approach to income tax.

The analysis of these proposed reforms is not directly comparable to the analysis of the tax and benefit reforms that the other parties have proposed, in part because Labour has not yet budgeted for their introduction. In addition, a number of details of how these policies will operate remain undetermined.

## 10.1 Three new credits

The Labour manifesto repeats recent government proposals to introduce three new credits in 2003–04: an integrated child credit, an employment tax credit and a pension credit. The manifesto contains very little detail on how these would work, so the analysis below is based upon previous government documents.[1] Neither main opposition party is committed to the introduction of these credits, so we consider them as specifically Labour proposals.

The integrated child credit for families with children would bring together the child-related payments in income support, the working families' tax credit (WFTC) and the children's tax credit.[2] It would be paid direct to the main carer (usually the mother) alongside child benefit. The credit would be means-

[1] See HM Treasury, *Tackling Poverty and Making Work Pay: Tax Credits for the 21st Century*, The Modernisation of Britain's Tax and Benefit System no. 6, HM Treasury, London, 2000, for the integrated child credit and the employment tax credit, and Department of Social Security, *The Pension Credit: A Consultation Paper*, DSS, London, November 2000, for the pension credit.

[2] See M. Brewer, M. Myck and H. Reed, *Financial Support for Families with Children: Options for the New Integrated Child Credit*, Commentary no. 82, IFS, London, 2001 (http://www.ifs.org.uk/taxben/icc.shtml), for more detailed consideration.

tested upon the joint income of a couple. Around 80% of the 7 million families with children in the UK would be eligible for some integrated child credit, with the poorest families receiving £36 a week for the first child and £26 for subsequent children. It is intended for introduction in April 2003, and it would cost around £1bn to ensure that no families on means-tested benefits lost out during the transition. It is possible, depending on the precise details of implementation, that some dual-earning higher-income families with children could lose out.

The employment tax credit would extend the principle of the WFTC to around 500,000 low-income working families without children.[3] Eligibility would probably be restricted to adults over 24 working full-time, and it could be worth up to £59 a week for a couple (perhaps less for a single person). Like the integrated child credit, it would be means-tested upon the joint income of a couple. It would cost around £0.5bn.

The pension credit is designed to allow pensioners to benefit from modest private incomes.[4] It is planned that this would be introduced at the same time as increases in the minimum income guarantee (MIG) – of £100 per week (in 2003–04 prices) for a single pensioner, for example. The costs and distributional effects of this benefit increase were included in the analysis in Chapter 5, so this chapter considers the accompanying structural reform in isolation from the increase. The most important element of such reform is the replacement of pound-for-pound withdrawal of MIG in respect of any income a pensioner has, with a 'taper', which would mean the pensioner would only lose 40p in benefit for each pound of private income they have secured in addition to their basic pension.[5] The benefit would be completely withdrawn for a single pensioner when net income before the credit reaches about £135 per week. It would cost around £900m to introduce, and around half of all pensioner households could be entitled to some pension credit.

These three new credits would blur further the distinction between the tax and benefit systems, and they might even achieve some genuine integration. The pension credit does not represent tax and benefit integration – it is really only an extension of the means-tested income support. But it might have a very different feel from income support as it would have an infrequent – perhaps annual – means test and no capital limits. The integrated child credit, though, represents a genuine integration of elements of the tax and benefit systems, as it would combine the child-related elements of means-tested benefits (income support and WFTC) and the Pay-As-You-Earn income tax system (the children's tax credit) to create a transfer that operates in the same way for all families with children in the UK.

---

[3] See Chapter 7 of A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2001*, Commentary no. 83, IFS, London, 2001 (http://www.ifs.org.uk/gbfiles/gb2001.shtml).

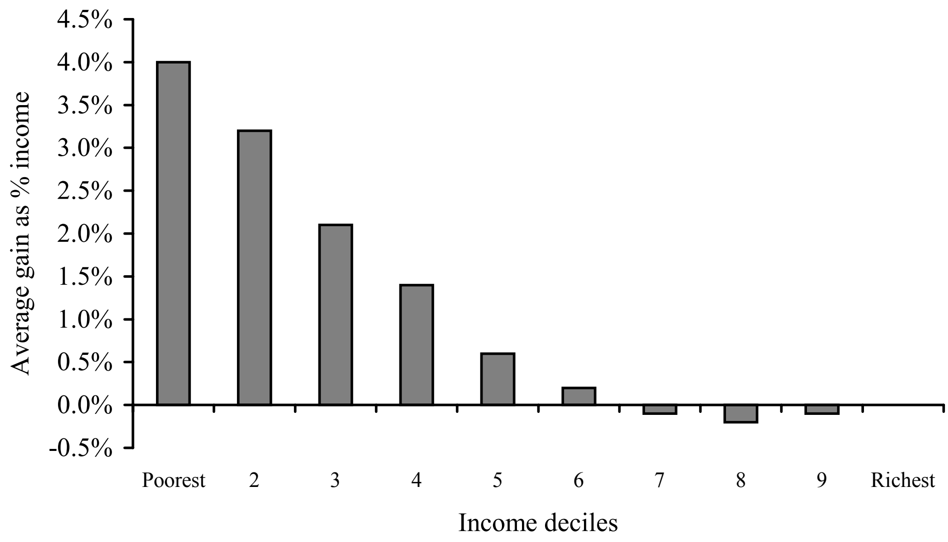
[4] See T. Clark, *Recent Pensions Policy and the Pension Credit*, Briefing Note no. 17, IFS, London, 2001 (http://www.ifs.org.uk/pensions/bn17.pdf), for more detailed consideration.

[5] Interaction with other means-tested benefits could mean that, in practice, significantly more than 40p in benefit is forgone for each pound of private income.

## Distributional effects

We now turn to consider the distributional effect of all these credits, under particular assumptions regarding the details of how the credits will operate.[6] Granting these, we estimate that, taken together, the credits could cost around £2.5bn a year. Figure 10.1 shows the average change in household disposable income that would be felt in each income decile.

**Figure 10.1. Gains from Labour's proposed new credits**




Note: Assumes full take-up of the new credits and reflects a number of assumptions on how the credits will work.
Source: The IFS tax and benefit model, TAXBEN, run on 1996–98 Family Resources Survey data.

The credits are roughly progressive, with the gains concentrated in the lower deciles, and higher deciles losing slightly (as we have assumed that some families who are receiving the children's tax credit would not receive the integrated child credit). The gains are also progressive in cash terms, with the poorest two deciles gaining around £6 a week and the top three deciles losing under a pound a week. The progressive tenor of these reforms is consistent with the direction of many of the tax–benefit reforms introduced by the Labour government during the last Parliament.

Table 10.1 presents the average gains by family type. Families are presented in three sub-groups: families with children, pensioners and others. Of families with children, it is the two-earner couples who do least well, actually losing out under our assumptions about the operation of the integrated child credit.

---

[6] Alternative ways in which each of the credits could operate are discussed respectively in M. Brewer, M. Myck and H. Reed, *Financial Support for Families with Children: Options for the New Integrated Child Credit*, Commentary no. 82, IFS, London, 2001 (http://www.ifs.org.uk/taxben/icc.shtml), Chapter 7 of A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2001*, Commentary no. 83, IFS, London, 2001 (http://www.ifs.org.uk/gbfiles/gb2001.shtml) and T. Clark, *Recent Pensions Policy and the Pension Credit*, Briefing Note no. 17, IFS, London, 2001 (http://www.ifs.org.uk/pensions/bn17.pdf)

On average, all other classes of families with children gain, and it is workless couples and single parents (many of whom are without work) who fare best. The pension credit should produce comparable weekly gains in the household budgets of single and couple pensioners, each of whom will gain on average over £3 a week. Under our assumptions, childless families of working age will make more modest gains, despite the employment tax credit. In this respect, the introduction of the three credits would mirror Labour's fiscal reform during this Parliament, which, as seen in Chapter 5, has also principally helped pensioners and families with children.

**Table 10.1. Average weekly gains from three new credits by family type**

| Family type | Average weekly gain |
|---|---|
| *Families with children* | |
| Single-parent family | £6.63 |
| No-earner couple with children | £9.05 |
| Single-earner couple with children | £3.95 |
| Two-earner couple with children | –£1.18 |
| *Pensioners* | |
| Single pensioner | £3.18 |
| Pensioner couple | £3.24 |
| *Others* | |
| Single, not employed | None |
| Single, employed | £0.97 |
| No-earner couple without children | None |
| Single-earner couple without children | £1.45 |
| Two-earner couple without children | £0.51 |

Note and source: As Figure 10.1.

The proposed new credits may all treat claimants with savings more generously than have traditional social security benefits, which have typically had stiff capital limits. The pension credit, in particular, is motivated by an explicit desire to reward saving. These policies show that the government is concerned to encourage low-income families to build up financial capital. The next section considers its new proposals to secure this goal more directly.

# 10.2 Asset-based welfare

## Proposals for consultation

Labour is proposing two new asset-based welfare policies – the Child Trust Fund and the Saving Gateway. These had previously been discussed in the consultation document, *Saving and Assets for All*, where it was proposed that there should be further consultation about these policies in the autumn.[7] This section outlines what, at this early stage of the consultation process, we do and do not know about the form that these policies would take.

[7] HM Treasury, *Saving and Assets for All*, The Modernisation of Britain's Tax and Benefit System no. 8, HM Treasury, London, 2001.

*The Child Trust Fund*

This would be a savings account opened at birth for all children. It seems certain that the fund would have the following features:

- the government would pay an initial contribution into the account, (this element of the policy explains why it has become popularly known as the 'baby bond');
- the size of the initial contribution would vary inversely with household income, but all households would receive something;
- the assets would become available to the child when he or she reached early adulthood, possibly at age 18;
- family and friends would be given incentives to make supplementary contributions to the accounts.

There are many features of the scheme that remain unspecified:

- How generous would the initial payment be?
- Would it be supplemented by further state contributions later in the child's life?
- Would supplementary contributions receive tax relief, or would incentives to make these payments be provided by some other means?
- How active a role should families and/or children have in deciding how the funds are invested?
- What would be the best way to build financial education into the scheme?
- At what age should children get access to the funds, and should there be any restrictions controlling how the funds can be spent?

The 'illustrative examples' discussed in the final chapter of *Saving and Assets for All* give us a stronger hint about the form that the Child Trust Fund might take. These examples envisage a scheme that would pay an initial contribution of £500 to the poorest families, with further contributions of £100 when the child reaches ages five, 11 and 16. Richer households would get half these amounts. Assuming that the funds accumulated at a 5% real interest rate, the maximum state contributions would be worth approximately £1,640 when the child reached the age of 18.[8] Assuming that the scheme was set up in such a way that half the recipients would receive £500 and half would receive £250, and that children that have already been born would not be eligible for the age-triggered payments, the policy would cost approximately £300m in its first year.[9] The annual cost would rise somewhat as children reach the ages to qualify for the supplementary payments.

[8] It is assumed here that the interest is added annually and that the supplementary £100 contributions are uprated in such a way as to maintain their real value.

[9] This assumes 720,000 births in the year, which is approximately the number of births per year in the UK. See Office for National Statistics, *Annual Abstract of Statistics*.

*The Saving Gateway*

This would be a new type of savings account that would almost certainly have the following characteristics:

- only households with low income would be eligible to open an account;
- eligible households would be given strong incentives to divert some of their current income or assets into the account;
- incentives would be provided by the state paying money into the account to match a household's contributions, up to some maximum amount, thus hugely increasing the effective return received on these matched savings.

As with the Child Trust Fund, there are many features of the Saving Gateway that remain unspecified:

- What would be the eligibility criteria for the accounts?
- If eligibility is determined by an income test, would this involve household or individual income?
- Would changes in circumstances be taken into account when deciding on eligibility, and, if so, how?
- At what rate would matching occur?
- For how long would households be able to keep their accounts open?
- Would households be allowed to open second and subsequent accounts if they continue to satisfy the income criteria for eligibility after closing a first account?
- Would savers be allowed complete freedom to decide what they would do with their asset at the end of the 'gateway period'?
- If households are to be able to transfer their savings from these accounts into instruments such as individual savings accounts (ISAs) or stakeholder pensions, what implications does this have for the tax treatment of the accounts (and the other instruments)?
- Would savers be allowed access to their funds during the 'gateway period'?
- What would be the method for delivering financial education in conjunction with the Saving Gateway?

The illustrative examples in *Saving and Assets for All* are calculated assuming that: eligibility for the scheme would be determined according to some income test; the accounts would run for three years; contributions would be matched on a pound-for-pound basis up to a maximum of £50 per month. Without any more specific proposals, it is not possible to estimate how much the scheme would cost the exchequer. Furthermore, even with specific proposals, it would be difficult to cost a scheme that is intended to induce households to change their behaviour.

## A rationale for asset-based welfare?

The Saving Gateway and the Child Trust Fund are two distinct policies. None the less, they share the common form of being 'asset-based' welfare policies: they both provide financial assistance to low-income households in the form of assets. We have highlighted above the fact that many things about the form of the proposed policies remain unresolved. This in part reflects the fact that the precise purpose of the policies – the failure that they are intended to correct – also remains vague. The proposed extended consultation period should help to clarify the rationale for the policies, which would in turn inform decisions as to their form. This section considers some possible justifications for asset-based welfare and comments on their validity.

The proponent of asset-based welfare must explain why it is a good idea to provide financial support to low-income households in the form of assets, rather than providing income and allowing families to choose whether or not to save. In a world where individuals rationally distribute lifetime income between consumption in each period, and in which everyone has access to credit markets, it is hard to see any advantage of asset-based welfare over income supplements. Families who were able to borrow against any asset that they were given, or save from their income, would choose to do so if this were the best way to allocate their resources, and so would be indifferent between receiving assets and receiving income. If opportunities to borrow are more restricted than opportunities to save, or if borrowing incurs a punitive interest rate, then households would prefer to receive income. A justification of an asset-based policy must depend on some feature of the world that is not adequately captured in this description and that would result in gains from increasing the asset holdings of poor people that outweigh the costs of the scheme.

Support for the proposed asset-based policies could be based on a view that it is equitable to extend incentives to save lower down the income distribution. Non-taxpayers do not benefit from existing tax breaks on savings instruments, and the capital limits for benefit eligibility make saving unattractive to those at the bottom of the income distribution. However, these points do not explain why it is good to have low-income households holding and accumulating assets.

If the policies are seen as a means of redistributing wealth, then support for them could be founded on the value judgement that a more even distribution of lifetime wealth between individuals is intrinsically good.[10] The government has not tended to take this line, but has argued that asset holding can help people to improve the outcomes that they achieve. This argument draws on evidence that asset holding has an 'independent effect on individuals' life chances'[11] in terms of outcomes such as health, education and employment

[10] A snapshot view certainly shows that current personal wealth is very unevenly distributed between individuals in the UK. See Box 2.3 in Chapter 2 of HM Treasury, *Saving and Assets for All*, The Modernisation of Britain's Tax and Benefit System no. 8, HM Treasury, London, 2001.

[11] Speech by David Blunkett to the Institute for Public Policy Research, 7 June 2000.

status, over and above that of income.[12] We now consider some reasons why such a link between asset holding and outcomes might exist, and what implications this has for the potential effectiveness and preferred form of asset-based welfare policies.

### *Learning to plan for life*

One reason why people who hold assets might achieve relatively good outcomes is that they tend to be people who plan ahead. It is possible that this kind of attitude causes both asset holding and the achievement of good outcomes. This means that it is difficult to interpret evidence that asset holding is positively correlated with good outcomes as meaning that the former causes the latter. Furthermore, if the attitude of forward planning is crucial, then asset-based policies would not help to improve the outcomes achieved by the asset recipients any more than would income-based policies, unless they help to teach people to adopt a forward-looking outlook. Evidence is required to support the claim that giving people assets can teach them to plan ahead, but it is possible that giving assets to those who would not otherwise have had them could at least help to break down barriers such as lack of knowledge and trust of financial assets. If saving is a habit-forming activity, then this provides another route by which incentive schemes that get people to begin saving might induce them to continue to engage in this forward-looking activity.

It also seems plausible to argue that the policy is more likely to affect participants' attitudes if financial education is a part of the schemes. Initial evidence from experiments with matched savings in individual development accounts (IDAs) in the US suggests that moderate amounts of financial education (six to 12 hours) increase the amount that participants save;[13] other evidence suggests that regular financial education is needed in order to have a significant impact on saving behaviour.[14] It can also be argued that, whilst financial education is an important part of the overall package, giving this education in isolation would be ineffective because people would not take the advice seriously if they were not active savers. The government's initial consultation document suggests that there would be an element of financial education in any asset-based policies that are enacted.

---

[12] J. Bynner and S. Despotidou, *Effect of Assets on Life Chances*, Centre for Longitudinal Studies, Institute of Education, London, 2001, is cited as UK evidence in support of this claim. G. Kelly and R. Lissauer, *Ownership for All*, Institute for Public Policy Research, London, 2000, summarises some other evidence, including US evidence, to support this claim. We comment further on this evidence below.

[13] See M. Schreiner et al., *Saving and Asset Accumulation in Individual Development Accounts: Downpayments on the American Dream Policy Demonstration: A National Demonstration of Individual Development Accounts*, Centre for Social Development, George Brown Warren School of Social Work, Washington University, St Louis, 2001.

[14] See B. D. Bernheim, D. M. Garrett and D. M. Maki, 'Education and saving: the long-term effects of high school financial curriculum mandates', *Journal of Public Economics*, vol. 80, pp. 435–66, 2001, and B. D. Bernheim and D. M. Garrett, 'The determinants and consequences of financial education in the workplace: evidence from a survey of employees', Stanford University, Working Paper no. 96-007, 1996.

### *Intergenerational mobility*

By intergenerational mobility, we mean the opportunity for individuals to move to a different part of the income (or wealth) distribution from that which their parents occupied. With respect to the policies under consideration in this section, the hope would be that the Child Trust Fund might help youngsters from families near the bottom of the income distribution to achieve high incomes relative to those of their parents. This kind of effect might be deemed particularly desirable, given evidence that children from low-income households find it difficult to move up the income distribution.[15] Whether or not one thinks that the policies proposed might be effective in this regard depends on whether or not one thinks that asset-based policies are the best way of providing youngsters from disadvantaged households with opportunities that they would not otherwise have.

### *Tackling credit constraints*

One reason why those who hold assets might achieve better outcomes than those who do not is that the wealth can be used to fund large expenditures more cheaply than is possible for individuals who are forced to borrow. Giving assets to the poor might help to equalise this disparity. An 18-year-old who gains access to their Child Trust Fund could (ignoring possible restrictions on how the fund can be used) use the money to help fund further education or training, for travelling in a 'gap year', for property purchase or to start a new business, for example. Giving all youngsters more equal access to these opportunities might be valued on grounds of equity.

Even if one accepts such an argument, it is not clear that the Child Trust Fund is the best way to provide the opportunities. More direct interventions such as subsidised loans or grants are also possible. Additionally, the amounts involved in the current proposal would represent a small contribution to the cost of a year in education or that of a property purchase. This suggests that the case for the Child Trust Fund must rest not only on the expenditure opportunities that it opens up to young people from less wealthy backgrounds, but also on the other benefits of making young people asset holders, which are discussed elsewhere in this section.

### *Enabling people to cope with 'unforeseen' circumstances*

The government cites the fact that assets can act as a 'cushion for families if they are hit by unemployment or other unexpected adversity'[16] in support of its proposals. It is true that savings provide this kind of buffer, but it is not clear that this justifies the cost of giving people assets rather than providing help through a social safety net. The safety net is a better-targeted way of providing assistance since it will only pay out to individuals who suffer a particular contingency. The extra cost of providing assets might be justified if there is evidence that individuals benefit from the knowledge that they are

---

[15] See P. Johnson and H. Reed, 'Intergenerational mobility among the rich and poor: results from the National Child Development Survey', *Oxford Review of Economic Policy*, vol. 12, no. 1, pp. 127–42, 1996.

[16] Paragraph 1.4 of HM Treasury, *Saving and Assets for All*, The Modernisation of Britain's Tax and Benefit System no. 8, HM Treasury, London, 2001.

likely to be able to cope with future contingencies without becoming financially dependent on the state.

On the other hand, such peace of mind might in itself increase the cost of the policy if it makes people less averse to the risk of unemployment and so less inclined to work hard to avoid becoming unemployed or to search hard for new work. The means test for the policy might also give people an incentive to reduce their labour supply in order to reduce their income and qualify to receive the (largest available amounts of) assets. So, whilst providing people with assets might provide some insurance against unexpected adversity, the policy must be carefully designed to take into account any behavioural incentives that might increase the likelihood of unemployment.

## Some problems with the policies

### *Can new saving be created?*

One motive for introducing the Child Trust Fund and the Saving Gateway would be to encourage low-income households to save more and to turn some families who would not otherwise have saved into asset holders.[17] Although the Saving Gateway in particular would provide strong financial incentives to low-income households to save, it is not necessarily true that the policies would lead to all eligible households increasing the amount that they save. Both policies have a positive impact on the wealth of the households affected. Suppose that some of these households aim at a certain level of asset stock to provide for their children or to provide insurance against unforeseen contingencies. This level of asset holding could be achieved with less saving out of current income after the asset-based policies have been enacted, and so the households might be induced to save less, not more, out of current income. The problem is likely to be particularly acute with the Saving Gateway. Households that would have saved a little without encouragement are the most likely to choose to enrol on the scheme, and at least some of their saving would be accounted for by transfers out of other assets, not new saving.

These problems could be largely circumvented by careful targeting of the policies towards low-income households that would save little or nothing without encouragement. Some new savings would also be created if the matching element of the policy were generous enough to ensure that the incentives created would outweigh the wealth and asset-switching effects discussed above. On the other hand, very generous matching might induce some households to borrow (either from financial intermediaries or from family or friends) in order to save at a profitable effective rate of return. There might be some concern if this odd portfolio allocation were observed. Qualitative evidence from experiments with matched savings in the US suggests that at least some of the saving in IDAs is non-borrowed new saving.[18]

[17] Paragraphs 1.5 and 1.6 of HM Treasury, *Saving and Assets for All*, The Modernisation of Britain's Tax and Benefit System no. 8, HM Treasury, London, 2001.

[18] See A. Moore et al., *Saving, IDA Programs and the Effects of IDAs: A Survey of Participants*, Research Report, Center for Social Development, Washington University, St Louis, 2001 (http://gwbweb.wustl.edu/users/csd/).

***Should people on low incomes be saving?***

We argued above that targeting the Saving Gateway at low-income households is one way to ensure that it generates new saving and savers. However, it is not obviously desirable to encourage this income group to forgo current consumption. The total amount of consumption that they can fund is small and hence these households might have good reason to think that they cannot afford to save. The problem would be compounded if saving incentives were to be integrated into the Child Trust Fund, thus encouraging families to forgo current consumption at a time when needs are increasing with family size. These considerations perhaps explain why the traditional approach favours giving welfare assistance via income supplements that can be spent immediately. They also suggest that policies encouraging saving out of current income might be best directed towards the working poor rather than towards the poorest recipients of welfare benefits.

The issue is further complicated by the fact that, whereas savings are held for forward-looking reasons, an eligibility test based on current income does not take future circumstances into account. This might result in some households with high lifetime income being assessed to be eligible to receive assets because current income is low, and, conversely, some households with low lifetime income but high current income being assessed to be ineligible. Leaving this issue aside, we can also ask how low current income might be related to expected future income and so to the desire to save. Households with low current income might expect their circumstances to improve. It might not be optimal for such households to be saving from current income, and indeed they might even be wise to borrow against future income.

***Controlling the use of funds***

If part of the aim of the Child Trust Fund is to encourage spending on certain things, such as further education or training, then it may be decided that there should be restrictions placed on how the funds can be spent. From a practical point of view, this might be difficult to do if youngsters can substitute between expenditure from this part of their budget and expenditure out of current income. The problem would be small if the largest funds were given to youngsters who would otherwise have spent very little on the designated purposes. On the other hand, if the reason for their low spending is that they gain little from such expenditures, then having such restrictions would reduce the benefits of the policy. It would seem necessary to allow some flexibility in how the funds can be spent in order to ensure that children from low-income backgrounds really do benefit.

# 10.3 Labour policy on income tax

The Labour manifesto makes two main pledges on income tax:

- to extend the 10p tax band;
- not to raise the basic or top rate of income tax.

The pledge to widen the 10% band is not by any specific amount, so it might be regarded as an ‘aspiration’, like the Liberal Democrat aim of abolishing the

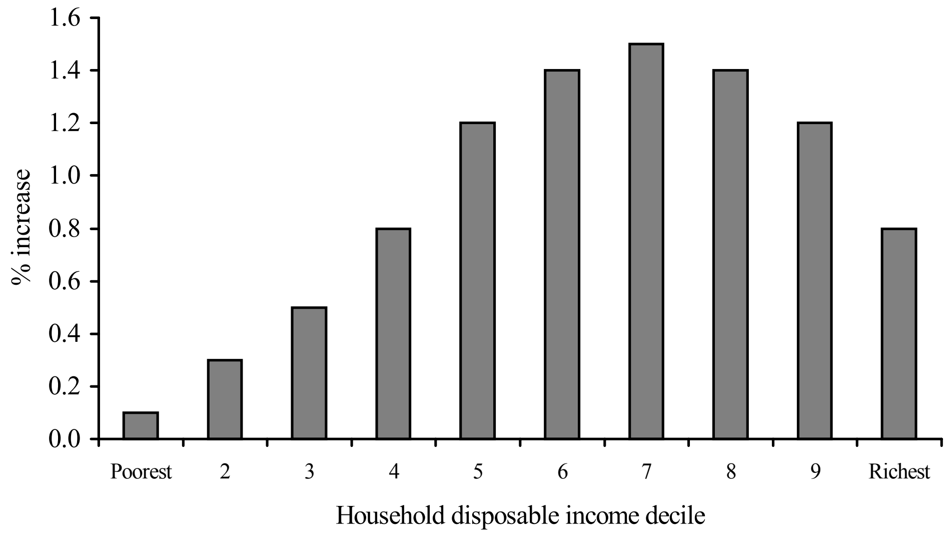
10% band and the Conservatives' longer-term target of raising the higher-rate threshold.

Labour could double the width of the 10p starting-rate band of income tax to £3,760 at a cost of about £4.9bn. If this occurred, the typical gross income required before the basic rate was payable would increase from £6,415 to £8,295.[19] Figure 10.2 shows the effect across the household income distribution. The poorest 30% of households would gain little, as most do not have sufficient income to pay income tax and so cannot gain from its reduction.

To gain in full from this reform, an individual must have an income of £8,295 or more – for only in this case do they possess the full range of income on which the marginal tax rate has been reduced. There are more such individuals in higher income deciles than lower, so, in cash terms, it is the top two income deciles that gain most – families in both stand to gain over £7 a week each, compared with average cash gains of £1 a week in decile 3 and £5 a week in decile 6. The more the 10p band is widened, the higher the income required to gain from it in full. This means widening the 10p band grows steadily less progressive.

In proportional terms, though, the tax cut brings most benefit to families in the upper-middle of the income distribution. This is because every individual in receipt of an income in excess of £8,295 receives a flat-rate cash gain of about £4.35 a week. Proportionately, this is worth more to those with incomes only modestly above this level, rather than those at the top of the income distribution. So Figure 10.2 shows that proportional gains peak at 1.5% in decile 7 before falling back to 0.8% for the top decile.

**Figure 10.2. Distributional effects of doubling the width of the 10% starting-rate band of income tax to £3,760**




Source: The IFS tax and benefit model, TAXBEN, run on 1998–99 Family Resources Survey.

[19] Throughout the discussion, we assume a childless individual born after 1935 with no special tax allowances or credits.

The pledge not to raise the higher or basic rate of income tax is repeated from the 1997 manifesto. Of course, it does not preclude increases in other taxes, but it does not even rule out rises in income tax itself. Income tax can be increased by cutting back on tax allowances (as the married couple's allowance was abolished in this Parliament), by extending the income tax base or by reducing the income at which particular rates are payable. Reducing the threshold at which the basic rate begins to be charged is incompatible with the proposal to widen the 10p band, but the higher-rate threshold could theoretically be cut.

But these alternative means by which to raise income tax grow more difficult to find as they are increasingly exploited. Many tax allowances are already less generous than they used to be, and the attraction of reducing the higher-rate threshold might be judged to be reduced by the large growth in the number of higher-rate taxpayers that the last two decades have already witnessed. Policies that increased the marginal rates faced by some without altering the formal level of income tax rates – for example, through restricting the personal allowance – might be judged to go against the spirit of the income tax pledge. Similar charges might be levelled against policies that could be used to raise money in a manner that mimicked the effects of increasing income tax rates – for example, raising National Insurance rates.

During the last 20 years, when resources have been available for tax cuts, they have very frequently been delivered by cuts in income tax rates. At the same time, tax increases have been implemented in alternative ways. This asymmetry risks making alternative means of increasing tax less attractive. In doing so, it makes a pledge to avoid higher income tax rates an increasingly significant constraint on tax policy.

# 10.4 Conclusions

In the first section of this chapter, we discussed three credits that the Labour Party intends to introduce if re-elected – the integrated child credit, the pension credit and the employment tax credit. We saw that the introduction of these credits would be consistent with the direction of many of the reforms to taxes and benefits that have been introduced by the Labour government during the last Parliament. They would be progressive and also continue the shifts towards joint assessment, integration of (or at least a blurring of the distinction between) taxes and benefits, and the use of means-tested benefits.

Like the credits, the Child Trust Fund and Saving Gateway proposals would show certain continuities with much of the tax–benefit reform introduced in the last Parliament: the policies would increase state support for children, low-income children in particular. The 'asset-based' means of delivery, however, is new. We have highlighted the need for careful thought about precisely why it might be better to provide people with assets rather than income. If the motivation is to encourage forward planning amongst young people and to aid intergenerational mobility, then maybe carefully designed policies could achieve some success. However, the policies involve a financial cost and, in assessing them, we must be careful to consider whether this money could be better used. Traditional income benefits are not the only alternative. Another is providing direct subsidies to those undertaking education or training. Yet another would be provision of financial education. Education and training might represent a good way to help youngsters from poor backgrounds to achieve higher incomes than their parents; financial education might be a good way to encourage forward planning.

Asset-based welfare has many potential aims, some of which constitute more convincing rationales for the approach than others. Should Labour win the election, before more detailed policies are settled it will be important to specify more precise objectives. Once these are known, consultation will be important in determining the exact shape the policy should take.

*Mike Brewer, Tom Clark and Matthew Wakefield*

# 11. The structure of welfare

Chapters 8, 9 and 10 analysed the precise distributional impacts of the parties' proposals. This chapter looks at whether we can see a difference between the parties in their approach to taxes and benefits and the treatment of the unemployed, and how their proposals relate to what we have seen during the first term of a Labour government.

Labour was elected with few specific ideas about welfare. Tax credits did not feature in its 1997 manifesto, and there seemed to be early tensions within government, particularly on the balance between 'old Labour' insurance-based, universal policies and the 'new Labour' policy of 'targeted support for those that need it most', as Frank Field's departure showed. But after four years of reforms, it is easier to discern consistent trends in welfare policy. This chapter looks at some important principles about the way parties are approaching the tax and benefit system. In particular, it looks at:

- the generosity of government transfers;
- the use of means testing, and tax and benefit integration;
- family – rather than individual – assessment of taxes and benefits;
- policies for managing workless benefit claimants.

## 11.1 Welfare policy proposals

Box 11.1 summarises the policies considered in this chapter. The details of the parties' policies were given in Chapters 8, 9 and 10.

**Box 11.1. What are the major welfare policies proposed by the parties?**

**Labour Party**

- An integrated child credit, replacing and unifying the child-related payments in the tax and benefit system.
- A pension credit: an income top-up for pensioners with small amounts of private income.
- An employment tax credit for poor working families without children.
- Extension and tightening of the New Deal for the unemployed.
- Merger of the Employment Service and the Benefits Agency. More active case management of claimants of other non-working benefit claimants such as lone parents and sick and disabled people.
- Asset-based welfare for children and low-income households.

*For Conservative and Liberal Democrat policies, see next page.*

**Box 11.1 continued**

**Conservatives**

- A tax-cutting package for families with children;
- Small increases in state pension for older pensioners.
- Income tax cuts for pensioners.
- £0.5bn savings in housing benefit and a small cut in WFTC.
- Privatisation of the compulsory New Deals. Abolition of the New Deal for lone parents.
- Making non-working lone parents with no children under 11 look for work.
- Pension opt-out.

**Liberal Democrats**

- Increase of £5 per week in the basic state pension (£8 for couples), and much higher increases for the over-75s, but no corresponding increases in income support.
- Payment of state pension to all over pension age.
- Introduction of a partial capacity benefit.
- Payment of £200 a year to families with children on income support for more than a year.
- £0.5bn savings in housing benefit.

# 11.2 Generosity of state support

The Labour government made transfers through the tax and benefit system more generous, but mostly focused on children and pensioners. All parties are promising to increase support further for families with children and pensioners, but they have suggested different mixtures of universal benefits, means-tested benefits and tax changes for achieving that. The Labour Party is alone in proposing long-term goals that imply continual above-inflation increases in support for families with children and for pensioners.[1]

## The past government's record

Chapter 5 showed that most household types gained on average through personal tax and benefit changes made by the past government, but the gains were directed at families with children and pensioners. Just over a half of families in Britain contain either a pensioner or a child, but pensioners and

[1] The distributional impacts of each party's policies were analysed in Chapters 8, 9 and 10.

children are found in over 70% of the poorest 40% of families in Britain.[2] Single pensioners and lone parents are disproportionately likely to be poor, and this helps explain why a focus on these groups is progressive.[3] But couples with children and couple pensioners are less than proportionately likely to be poor, and this is why the government has used income testing to target its extra support.

**Table 11.1. Families with children and pensioners in the income scale**

| Family type | % of family type with income below 60% median |
|---|---|
| Pensioner couple | 23 |
| Single pensioner | 31 |
| Couple family with children | 21 |
| Lone-parent family | 59 |
| Couple family without children | 11 |
| Single adult without children | 22 |
| Average | 23 |

Note: The table shows, for example, that 23% of all families have incomes less than 60% of median income, but 59% of lone parents have incomes less than 60% of median income, after adjusting for household size.
Source: Table J1 of Department of Social Security, *Households Below Average Income, 1994/5-1998/9*, DSS, London, 2000.

So what has happened to means-tested benefit rates? Income support rates for families with children and for pensioners, and the support for low-income working families with children, have all risen in real terms since 1997 (see Table 11.2). Income support rates for a lone parent with two children under 11 are 25% higher in 2001 than they were in 1997 – even including the abolition of the lone-parent premium – and working families' tax credit (WFTC) rates for the same family are 37% higher than the equivalent family credit (FC) rates in 1997. These increases are greater than the real increase between 1988 – when these benefits were introduced – and 1997.

**Table 11.2. Maximum benefit and tax credit awards**

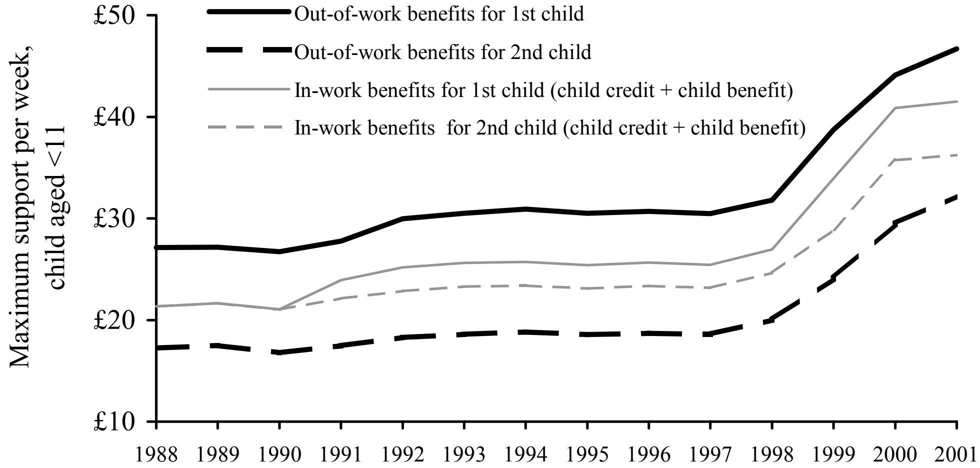
| Family type | April 2001[a] | Real increase, 1988–97 | Real increase, 1992–97 | Real increase, 1997–2001[a] |
|---|---|---|---|---|
| Single person | £53.05 | 1% | 2% | 0% |
| Lone parent, two children under 11 | £133.45 | 4% | 2% | 25% |
| Low-income working lone parent, two children under 11[b] | £111.00 | 27% | 17% | 37% |
| Single pensioner | £92.15 | 7% | 6% | 25% |
| Couple pensioner over 75 | £140.55 | 11% | 6% | 19% |

[a] Includes increases announced in Budget 2001 due in 2001.
[b] Shows maximum FC/WFTC award assuming full-time work.
Note: Real increases calculated using ROSSI index.
Source: Author's calculations from various DSS publications.

[2] Of the 30 million families in Great Britain, there are around 7 million families with children and 10 million families with at least one pensioner (source: author's calculations from the Family Resources Survey).

[3] 31% of single pensioners and 59% of lone parents are poor, compared with 23% of all family types – see Table 11.1.

**Figure 11.1. Real means-tested support for children**




Notes: Figure shows maximum extra support that families on means-tested benefits receive for children under 11, averaged over financial year in real terms. Does not include free school meals, the basic credit in FC or WFTC, support for childcare costs, the married couple's allowance, the additional personal allowance or children's tax credit.
Source: M. Brewer, M. Myck and H. Reed, *Financial Support for Families with Children: Options for the New Integrated Child Credit*, Commentary no. 82, IFS, London, 2001 (http://www.ifs.org.uk/taxben/icc.shtml).

Income support rates for pensioners – the government's minimum income guarantee – have risen considerably between 1997 and 2001: by 25% for a single pensioner and 19% for a couple pensioner over 75, for example. But benefits for able-bodied working-age adults without children have not changed in real terms since 1997.

The increase in support for low-income families with children reflects the substantial increase in the amount of money given specifically for their children. As Figure 11.1 shows, this support hardly changed in real terms between 1988 and 1997, but since 1997 there has been a real increase of 53% in the amount that families on income support receive for a child under 11, and an increase of 63% for families on WFTC.[4]

## Prospects for the next Parliament

No party is committing itself to across-the-board increases in benefit levels; all are promising to target extra support on the groups that were targeted by the present government – pensioners and families with children.

**The Labour Party** would introduce three new credits, as described in Chapter 10. As well as introducing the credits, the Labour Party is promising to increase the new pension credit in line with earnings, which would lead to continual increases in benefit levels for the over-60s. For families with children, the introduction of an integrated child credit would require a one-off change in the level of support for out-of-work or low-income working

[4] Children over 11 have seen a smaller increase since 1997 because the government has aligned the support given to children under and over 11.

families. Beyond that, there is no formal commitment to above-inflation increases in benefit levels for families with children. But Labour's long-run goal of eliminating child poverty is implicitly committing it to further real increases. In particular, if a future Labour government remains committed to its child poverty reduction targets, it is highly likely that it would need continual above-inflation increases in benefits for families with children.[5]

**The Conservative Party** is promising extra support for families with children and for pensioners, but both of these are to be delivered mainly through the income tax system (see Chapter 8). Other than a small rise in the state pension, there is little detail in the Conservative manifesto on what might happen to universal or means-tested benefit rates more generally.

**The Liberal Democrats** are proposing substantial increases in the state pension, with particularly large increases for older pensioners (see Chapter 9). But there are no proposals to increase income support alongside the state pension, meaning that the poorest pensioners will see little increase in incomes. The Lib Dems are proposing that families with children on income support for more than a year would gain by £200 a year, affecting around 15% of children. There are also a number of proposals that would increase benefits for disabled people. The use of universal rather than means-tested benefits means that the Liberal Democrats would have to worry less about ensuring take-up rates remained high.

## 11.3 Extending means testing and eroding the contributory principle

The last government focused its extra resources on the poorest families, and, in doing so, substantially increased the number of families entitled to means-tested benefits. It also diminished the importance of the contributory principle and National Insurance benefits.[6] The Labour Party's proposals for the next Parliament would continue these trends. The other parties do not propose any significant extensions in means testing: the Conservatives are proposing a small reduction in WFTC, and both the Liberal Democrats and the Conservatives are seeking to cut the spending on housing benefit. Instead of using means-tested benefits, the Liberal Democrats are proposing to increase non-means-tested benefits for pensioners, and the Conservatives are proposing to use the tax system to deliver support.

---

[5] The Department of Social Security and HM Treasury have a Public Service Agreement to make substantial progress towards eradicating child poverty by reducing the number of children in poverty by at least a quarter by 2004, and Labour's manifesto repeats the party's commitment to end child poverty by 2020 and halve it by 2010. Broadly speaking, to reduce child poverty measured relative to median income, a government would need to do some combination of the following: increase the proportion of children whose parents work; improve the targeting of financial support for children; raise total financial support for children as a share of GDP.

[6] Under the contributory principle, entitlement to and awards of certain social security benefits are linked to the amount of National Insurance contributions paid by an individual. The basic state pension, statutory sick pay and bereavement benefits are all examples of contributory benefits.

Compared with universal benefits, means-tested benefits allow governments to target money on the neediest families, either reducing the cost of providing support or allowing for greater support at the same total cost. But some argue this extension of means testing is undesirable. The most important concern is that the take-up rate of means-tested benefits is usually lower than that of universal benefits because, quite simply, people have to submit claims for means-tested benefits and not all who are entitled to claim do claim, either because they do not want to claim or because they do not know that they are entitled.[7] In addition, means-tested benefits are more expensive to administer and increase opportunities for fraud compared with universal benefits.[8] One economic disadvantage of extending means-tested benefits is that it can increase effective marginal tax rates. Opponents of means testing also portray it as an infringement of personal liberty and argue that it places too much power in the hands of government agencies. This view may depend, though, upon the form of means testing used by the Benefits Agency, under which claimants fill in long questionnaires to claim support and may have to report relevant changes in circumstances every week.

## The past government's record

Table 11.3 shows changes in the numbers of families on means-tested benefits since 1997.[9] For most of the means-tested benefits in the table, *fewer* people were claiming benefits in 2000 than in 1997. The exceptions are a 50% increase in the number of families with children receiving an in-work benefit (either family credit or the working families' tax credit) and a 20% increase in claimants of sickness or disability premiums in income support. Surprisingly, the number of pensioners claiming income support – the government's minimum income guarantee – is lower in 2000 than it was in 1997, despite above-inflation increases in generosity (although the caseload began to rise in 1999 from a level of 1.6 million).

There is more stability in the number of people receiving support from *any* means-tested benefit:[10] the number of working-age adults receiving a means-tested benefit has fallen by only 11%, as the falling number on jobseeker's allowance is partially offset by the increased numbers claiming WFTC and on

[7] Income support take-up rates are around 91%, but they are lower for pensioners and those without children. Take-up rates for family credit were around 76%. Source: Department of Social Security, *Income Related Benefits: Estimates of Take-Up in 1998-99*, DSS, London, 2000.

[8] The total direct staff cost for processing income support in 1999–2000 was £206m, or £53.70 per beneficiary. In the same period, benefit overpayment due to fraud and errors was estimated to be 8.4% of the total benefit paid. Sources: Department of Social Security, *Fraud and Error in Claims for Income Support and Job Seeker's Allowance*, DSS, London, 2000; Department of Social Security, *Public Service Agreement 2001-2004: Technical Note*, DSS, London, 2000.

[9] We are treating WFTC as a means-tested benefit here as it owes more in operation to means-tested benefits than it does income tax: claimants have to fill in an application form, entitlement is based on earnings over a short period (seven weeks to four months) and claimants face similar rules on capital limits to claimants of traditional means-tested benefits.

[10] See notes to Table 11.3 for a precise definition of which means-tested benefits are included; note that housing benefit and council tax benefit are excluded in this comparison.

income support for a disability or long-term sickness. The number of children in families on out-of-work means-tested benefits has fallen by only 2%, so, including in-work benefits, more children are in families receiving means-tested support in 2000 than in 1997.

**Table 11.3. Numbers of families on key means-tested benefits, 1997–2000**

| | Estimated caseload in: May 1997 | Nov. 2000 | % change, May 1997–Nov. 2000 |
|---|---|---|---|
| *Individual benefits for people out of work* | | | |
| Jobseeker's allowance | 1.6m | 1.0m | –38% |
| Jobseeker's allowance (income-related) | 1.2m | 0.7m | –41% |
| Income support: over-60s | 1.7m | 1.7m | –3% |
| Income support: lone parents | 1.0m | 0.9m | –12% |
| Income support: disabled | 0.8m | 1.0m | +20% |
| *Individual benefits for people in work or on a low income* | | | |
| FC/WFTC | 0.7m | 1.1m | +50% |
| Housing benefit | 4.6m | 3.9m | –16% |
| *All means-tested benefits by client groups (see notes below for exact definition)* | | | |
| Working-age adults | 5.7m | 5.1m[a] | –11%[b] |
| Children in out-of-work families | 2.7m[c] | 2.7m[d] | –2%[e] |

[a] August.
[b] May 1997 – August 2000.
[c] November.
[d] May.
[e] November 1997 – May 2000.
Notes: 'Working age' includes adults claiming WFTC/FC, disabled person's tax credit, jobseeker's allowance (JSA), incapacity benefit (IB), severe disablement allowance or disability living allowance (DLA). 'Children' counts dependent children in families claiming income support (IS), JSA, IB or DLA. There were also 2.3 million children in families claiming WFTC in November 2000, compared with 1.5 million in families claiming FC in November 1996; a small fraction of these will also be claiming IS.
Source: Author's calculations from various quarterly statistical enquiries, latest issues of which are on http://www.dss.gov.uk/asd/online.html.

What determines the number of people claiming means-tested benefits? There are four main factors:

- demographics (e.g. the size of groups that rely on state support, such as pensioners and families with children);
- economic changes (e.g. the number of people who are in work or receiving private pensions);
- the take-up rate of means-tested benefits;
- the generosity of means-tested benefits, as an increase in generosity means that more people are entitled.

To help determine which of these factors can explain the results above, Table 11.4 estimates the change in the number of families entitled to means-tested benefits due to changes in the generosity of benefits alone. It shows that discretionary policy changes increased the numbers entitled to income

**Table 11.4. Effect of policy changes on numbers of families entitled to means-tested benefits**

| | April 1997 | Estimated caseload April 2001[a] | % change since 1997 |
|---|---|---|---|
| Housing benefit | 4.7m | 4.7m | — |
| Income support | 4.7m | 5.4m | +17% |
| *of which:* | | | |
| Lone parents | 1.1m | 1.1m | +2% |
| Pensioners[b] | 1.5m | 2.2m | +46% |
| Others | 2.1m | 2.3m | +10% |
| FC/WFTC | 0.7m | 1.2m | +79% |

Notes: The estimates were based on Family Resources Survey data from 1996–98, and so measure changes in entitlement abstracting from changes in demographics. Full take-up of all benefits is assumed.

[a] Includes increases announced in Budget 2001 due later in 2001. The pre-announced increases in income support for the over-60s due in 2002 will mean a further 0.1 million families will be entitled to income support.

[b] People of pensionable age; families headed by a man over 60 but under 65 are included in the 'Others' category.

Source: Author's calculations from the IFS tax and benefit model, TAXBEN.

**Box 11.2. What has happened to the number of families on WFTC?**

The means-tested benefit that has seen the largest expansion in entitlement has been the working families' tax credit. There has been some concern that the government has failed to meet its caseload target of 1.4 million families.

The caseload is certainly below 1.4 million (there were 1.1 million families receiving WFTC as of November 2000), and successive Treasury forecasts have overestimated expenditure on WFTC: the estimated cost of WFTC in 2000 given in the March 2001 Budget was over 10% lower than the estimate in 1999, despite increases in its generosity since the latter date (Budget 1999 estimated the costs of WFTC as £5.1bn in 2000–01 and £5.4bn in 2001–02; Budget 2001 estimated £4.5bn and £5.3bn for the same years; see tables entitled 'Accounting and Other Adjustments' in Appendix C of both documents).

This suggests that either the government overestimated the take-up rate for WFTC or it overestimated the number of low-income families with children. There are no estimates yet of the actual take-up rate for WFTC, but evidence from family credit suggests that it took well over a year for families newly entitled to FC to claim it, and so the number of families claiming WFTC may continue to rise.

support; so the falls in the number of people claiming income support in Table 11.3 are probably due to demographics, changes in the economy or a change in the take-up rate.[11] Government estimates suggest that take-up rates for out-

[11] Tables 11.3 and 11.4 are not quite comparable: we have administrative data from November 2000, but we have modelled entitlement for April 2001.

of-work benefits have changed little over recent years, at around 83% for pensioners and 98% for lone parents.[12] Thus the most likely causes for the lower income support caseload are demographic and economic changes, such as fewer pensioners on low or no private pensions, and more lone parents in work. But the situation is more complicated for WFTC, as Box 11.2 discusses.

### *Have taxes and benefits become more integrated?*

Although the past government spoke much about integrating taxes and benefits (rather than just increasing means-tested benefits), progress was limited. One of the key reforms – the working families' tax credit – blurred the traditional distinction between taxes and benefits.[13] The government's view is that WFTC is now part of the tax system, as it is administered by the Inland Revenue and most recipients are paid through the pay-packet. One of the effects of relabelling WFTC as a tax credit was that the aggregate tax burden appeared to fall under the government's preferred measure, but this relabelling will not affect claimants' financial incentives or income.[14] As WFTC is assessed on the basis of a short-term income measure and is reassessed every six months, it looks very similar to its predecessor – family credit, a means-tested benefit – and has different rules and a separate structure from income tax.

### *What has happened to the contributory principle?*

Alongside this increase in means testing, the contributory principle has not fared well under the past government. There have been a number of changes to former National Insurance benefits that have made them look more like means-tested or universal benefits. For example, the maternity allowance has been extended to mothers with incomplete contributions records – making a contributory benefit more like a universal benefit. Awards of incapacity benefit is to be taxed at 50% for personal pension income that exceeds £85 a week from 2001 – making a contributory benefit more like a means-tested benefit. The government originally intended this reform to save a quarter of spending on incapacity benefit, but subsequent amendments reduced the savings. There were also changes to the system of benefits for widows (now bereavement benefits), which sharply reduced their cost, principally by paying

---

[12] Department of Social Security, *Income Related Benefits: Estimates of Take-Up in 1998-99*, DSS, London, 2000.

[13] Traditionally, taxes and benefits have had different objectives – the funding of government expenditure and the relief of need – and have been administered separately. An integration of taxes and benefits would mean that families are assessed once and receive one single transfer or tax demand. The main advantages would be increased take-up of existing benefits, reduced hassle for claimants and lower administrative costs for government. See A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2001*, Commentary no. 83, IFS, London, 2001 (http://www.ifs.org.uk/gbfiles/gb2001.shtml) for a discussion.

[14] Around a fifth of expenditure on WFTC offsets income tax liabilities – see Appendix B of A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2001*, Commentary no. 83, IFS, London, 2001 (http://www.ifs.org.uk/gbfiles/gb2001.shtml). Qualitative evidence suggests that many recipients are more concerned about receiving payments regularly than the form in which they are paid – see National Association of Citizens' Advice Bureaux, *Work in Progress: CAB Clients' Experience of the WFTC*, NACAB, London, 2001.

the new bereavement allowance (the old widow's pension) for a year only, making a previous contributory benefit much less generous.

## Prospects for the next Parliament

**The Labour Party's** future reforms would increase the number of people entitled to means-tested benefits by both further increasing the generosity of existing benefits and introducing new benefits.

The proposed pension credit would be available to around half – around 3.6 million – of all pensioner families, around 1.5 million more than will be eligible for income support in 2001. Integrating financial support for families with children would mean that around 6 million families with children could be eligible for an integrated child credit, nearly 3 million more than currently receive a means-tested benefit through income support or WFTC.[15] A new employment tax credit for families without children could go to around 500,000 working-age families. Overall, we estimate the Labour Party's proposed reforms could increase the number of families entitled to means-tested benefits by 3.4 million (considerably less than the sum of the totals above, as some of those newly entitled to one of Labour's credits are already entitled to receive housing benefit or council tax benefit).[16]

As discussed above, the main concerns over means testing are that it can increase effective marginal tax rates and that means-tested benefits tend to have lower take-up rates than universal benefits. The impact of the new credits on marginal tax rates is discussed elsewhere.[17] The Labour Party is aware that maximising take-up will be an important challenge and seems to be focusing on changing the way the new transfers work to make them seem very different from old-style means-tested benefits. For example, it is proposing to abolish the weekly means test and capital limits for the pension credit, perhaps making the means-testing process seem more like income tax assessment. There are also signs that the integrated child credit and the employment tax credit may move to a system of annual awards, adjusted only in response to a limited number of changes in circumstances. But in order to show that the integrated child credit and the pension credit are more effective in tackling low incomes than increases in, say, the state pension and child benefit, the Labour Party will need to ensure that take-up rates are high.

---

[15] Although most of these 6 million families with children are entitled to the children's tax credit this year, and so are already facing some form of joint assessment, as Section 11.4 considers.

[16] We estimate that the integrated child credit, employment tax credit and pension credit will extend means-tested benefits to 2.7 million, 0.3 million and 0.3 million families respectively once entitlement to housing benefit and council tax benefit is considered.

[17] See M. Brewer, M. Myck and H. Reed, *Financial Support for Families with Children: Options for the New Integrated Child Credit*, Commentary no. 82, IFS, London, 2001 (http://www.ifs.org.uk/taxben/icc.shtml), A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2001*, Commentary no. 83, IFS, London, 2001 (http://www.ifs.org.uk/gbfiles/gb2001.shtml), and T. Clark, *Recent Pensions Policy and the Pension Credit*, Briefing Note no. 17, IFS, London, 2001 (http://www.ifs.org.uk/pensions/bn17.pdf).

**Box 11.3. Saving money from the housing benefit budget**

Both the Conservative Party and the Liberal Democrats are pledging to save £0.5bn on housing benefit (HB) expenditure on private-sector tenants (people who are renting private accommodation). The parties are claiming that they would do this by cutting down on fraud. This might occur because private-sector landlords with tenants on HB can increase their rents knowing that the tenant will receive extra HB – up to a limit – to cover the increase; it might also occur because tenants and landlords can collude to defraud local authorities.

The extent of fraud in this area – and the degree to which the Liberal Democrats' and Tories' promised savings represent a crack-down on genuine fraudulent behaviour – is very difficult to determine. If the savings are found, and are all found by eliminating fraud or by driving down rents, then this would represent a welcome efficiency saving. But, alternatively, the savings could come by reducing HB payments, and the mooted savings represent around £13 a week for the average private-sector HB claimant. (£0.5bn is around 5% of the total HB budget, and there are 700,000 families on HB renting in the private sector. Source: Department of Social Security, *Housing Benefit Quarterly Statistical Enquiry, November 2000*, DSS, London, 2001.)

The Labour Party's two proposed policies to promote savings (the Child Trust Fund and the Saving Gateway) have an element of means testing in them, as discussed in Chapter 10. But by promoting saving amongst low-income families, the policies would attempt to reverse the traditional disincentive to save faced by people on means-tested benefits.

**The Conservatives'** proposals would reduce the number of people on means-tested benefits, as they are proposing to make a small cut in WFTC, would like to move lone parents with older children off income support and are hoping to cut the housing benefit budget (see Box 11.3 and Chapter 8). In other areas, they are proposing a reduction in contributory benefits, by insisting that employers pay for industrial injuries insurance and by allowing people to opt out of the basic state pension (see Appendix A). The Tories also propose to pay WFTC as a traditional means-tested benefit, direct to recipients, rather than having it paid by employers. They are proposing a small one-off increase in the state pension rather than increases in means-tested support.

**The Liberal Democrats** are proposing minor changes in means-tested benefits. The largest reform would be intended to save money from the housing benefit budget (see Box 11.3). They are proposing two offsetting reforms to income support for the over-60s: increasing the state pension without increasing income support levels, which should reduce the number of pensioners entitled to income support, but also removing the capital limits in income support for the over-60s, allowing some pensioners with low incomes but large savings to receive extra help. Over time, the Liberal Democrats want to make the state pension a universal, non-contributory benefit, which would benefit people with incomplete contribution records and could reduce the number of pensioners needing to claim income support, but would represent a move away from the contributory principle to a more universal approach.

They also want to reform incapacity benefit so that it can give support to people who are able to do some work but still have some form of disability or illness (which would strengthen the contributory principle).

## 11.4 Extending joint assessment and joint taxation

The number of families facing joint assessment increased under the past government, as means-tested benefits have increased and the new children's tax credit requires information on a family's earnings. No party is proposing a return to joint taxation in the future, but both Labour and the Conservatives are proposing reforms that would increase the number of couples assessed on their joint income, whether through the tax or benefit system. The Liberal Democrats' policies would reduce the number of pensioner couples facing joint assessment through income support by making non-means-tested benefits more generous.

Much of the debate around joint assessment focuses on whether taxation is joint or individual. Before the introduction of individual taxation in 1990, the income of a woman in a couple was treated and taxed as if it were her husband's. Since that date, women have been taxed as individuals in their own right. But whether we have joint or individual taxation is a narrow debate; a wider question is whether tax payments or benefit entitlement should depend upon an individual's income or upon the combined income of a couple. We shall use the phrase 'joint assessment' (rather than 'joint taxation') to refer to the second option.

Whether one is in favour of joint assessment partly depends on one's view about how couples share their income. Individual assessment is more appropriate if governments are concerned with individuals' own income, but joint assessment is more appropriate if governments believe that the combined income of a couple is more closely related to their actual standard of living. But there are other concerns with joint assessment. Joint assessment means that families have to provide government agencies with details of their relationships and be prepared to have these investigated. It also means that individuals in a couple have to share information on their incomes with each other. Sociologists argue that this can exacerbate existing gender imbalances of power within a relationship. Depending on the precise way in which joint assessment is implemented, it can affect the incentives for two single people to form a couple, and it could lead to a situation where the second earner faces a higher effective tax rate than the first earner.[18]

Between 1990 and March 2001, there was a clear dichotomy between the tax and benefit systems: a person's tax liability depended on her own income

[18] For example, N. Eissa and H. W. Hoynes, 'Explaining the fall and rise in the tax cost of marriage: the effect of tax laws and demographic trends, 1984-97', *National Tax Journal*, vol. 53, no. 3, part 2, pp. 683–712, finds that joint assessment in the US tax system leads to both financial incentives and disincentives to form a couple at various income levels.

only, and the financial position of any partner was immaterial,[19] but entitlement to means-tested benefits has always been assessed against joint family income. These two extremes are not the only options, though: there are a range of ways that we could treat couples, from full independence to full joint assessment. Table 11.5 lists these and shows how some of the parties' tax and benefit proposals (discussed more below) fit on this scale.

**Table 11.5. A range of possible tax and benefit treatments of families**

| Tax type | Information required on partner | Example |
|---|---|---|
| Fully independent | None | Tax system for families without children since 1990 |
| Independent with full transferable allowance | Whether married or have children | Married couple's allowance (1990–99) |
| Independent with selective transferable allowance | 1. Whether a higher-rate taxpayer | Children's tax credit |
| | 2. Whether engaged in unpaid caring or with children under 11 | Conservatives' semi-transferable personal allowance for married couples |
| Fully joint | Income | Pre-1990 system for taxing couples<br>All means-tested benefits<br>Pension credit<br>Employment tax credit<br>Integrated child credit |

## The past government's record

Although the government abolished the married couple's allowance, two developments over the last Parliament have shifted the balance away from individual assessment. First, as discussed in Section 11.3, the increased generosity of means-tested benefits, such as WFTC and income support for pensioners, means that more couple families are now potentially subject to joint assessment through the benefit system. Second, the children's tax credit, which will go to around 5 million families with children, represents a form of joint assessment in the tax system: couples who claim must nominate the higher earner, and the credit is withdrawn where this partner is a higher-rate taxpayer.

## Prospects for the next Parliament

**The Labour Party's** new credits are all due to be assessed on joint family income and so would certainly increase the extent of joint assessment in a similar way to increased means testing. For example, around 4 million couples with children would be entitled to the integrated child credit, compared with

[19] The married couple's allowance (MCA) depended on whether one had a married partner, not how well off they were, although couples could decide how to allocate the benefit of the MCA, meaning that there was a very small element of joint assessment.

around 1.3 million who are entitled to income support or WFTC. The pension credit would extend joint assessment to around 600,000 couple pensioners, and the employment tax credit could go to around 100,000 couples.

**The Conservative Party** has a number of proposals that would increase the number of families subject to joint assessment. First, the transferable tax allowance for married couples with young children or caring responsibilities would introduce an element of joint assessment into the tax system, as it allows the higher-earning partner to benefit from the lower-earning partner's personal allowance. Second, but less importantly, the increased children's tax credit for families with children under five would slightly increase the number of families who would be eligible for the credit. The Conservatives have also suggested that it would be better if the credit were tapered away according to the joint income of a couple (this would remove a discrimination against single-earner couples).

**The Liberal Democrats'** proposals to extend the scope and increase the value of the state pension will mean that fewer pensioners will need to claim income support.

# 11.5 The benefit system and workless claimants

The New Deal was the past government's flagship programme for dealing with the unemployed and involves a set of different policies designed to get the young unemployed back to work. The past government has also begun actively to manage other benefit recipients through the New Deal for Lone Parents, the New Deal for the Disabled, and early piloting of a single agency for all working-age benefit claimants, combining the roles of the Employment Service and the Benefits Agency. Both main parties are offering an extension of that approach. The Labour Party proposes to extend the New Deal to more unemployed adults and intensify it, and to extend the New Deal principles to people claiming other benefits (lone parents, sick and disabled people). The Conservatives, though, are proposing to scrap the New Deal and to involve the private sector more, effectively privatising the Employment Service's role as job-brokers for the unemployed. The Liberal Democrats also want to scrap the New Deal, but they propose to replace it with a flexible guarantee of help for all out-of-work jobseekers. They would not introduce any more sanctions.

## The past government's record

The last government introduced the New Deal in January 1998, financed by the windfall tax on the privatised utilities.[20] There is now a compulsory New Deal for people aged between 18 and 24 who have claimed jobseeker's allowance for six months, as well as a compulsory New Deal for the long-term unemployed. There are also voluntary New Deals, involving assistance with

[20] The windfall tax raised £5.2bn between 1997 and 1999, but not all of this has been spent on labour market programmes, as the labour market has performed better than expected.

no sanctions, for lone parents, partners of the unemployed, those over 50 years old and disabled people. These are all summarised in Table 11.6. The New Deal represents a continuation of a trend begun in the 1980s, when successive Conservative governments changed the conditions for receipt of unemployment benefits, such as the RESTART initiative.

**Table 11.6. The New Deal programme**

| Client group | Conditions and eligibility | Provision |
|---|---|---|
| 18- to 24-year-olds | Compulsory after unemployed for six months | Personal adviser. Gateway period for four months (advice, guidance, preparation), then one of: training or education, job with wage subsidy, voluntary work, public sector employment through the environmental task force. Help with travel and childcare costs. |
| 25- to 50-year-olds | Compulsory after unemployed for 18 months | Personal adviser. Gateway period for four months (advice, guidance, preparation), then one of: training or education, job with wage subsidy, work placements. Help with travel and childcare costs. |
| Aged 50 and over | Voluntary after unemployed for six months | Personal adviser. Help with job search. One year's employment credit if move into low-paid work. |
| Lone parents | Voluntary for lone parents who are not working | Personal adviser. Help with job search, training, childcare arrangements and in-work support. Financial help for training and childcare. May join other New Deals. |
| Partners of unemployed people | Voluntary if partner claiming out-of-work benefit for six months | Personal adviser. Help with job search, training, childcare arrangements and in-work support. Financial help for training and childcare. |
| Disabled people | Voluntary if receiving disability-related benefits | Personal adviser and access to job broker. |

Source: Appendix 10 of Child Poverty Action Group, *Welfare Benefits Handbook 2001/2*, CPAG, London, 2001.

What impact has the New Deal had? The claimant count of unemployment fell below 1 million early in 2001, to reach its lowest level for 25 years. The government has claimed the New Deal for Young People to be a success, as it has met its 1997 manifesto pledge of moving 250,000 young people into work, reducing youth unemployment by 75%. But an assessment of the success of the New Deal needs to estimate how many people would have found work in the absence of the programme. One study estimated that the New Deal for Young People (NDYP) seems to have successfully increased net employment. Young unemployed men are about 20% more likely per period to gain jobs as a result of the New Deal gateway period, and it may have led to a sustainable increase in youth employment of over 17,000. The same study estimated that the net exchequer cost per additional employee from the NDYP is around

£12,000 and, more importantly, that social benefits exceeded social costs.[21] An evaluation of the New Deal for Lone Parents's (NDLP's) prototype found that it had had a small positive effect on the number of lone parents moving off income support: after 18 months, the number of lone parents on income support was 3.3% lower than it would have been in the absence of the programme, with 20% of jobs gained through the NDLP additional to those that would have arisen without the programme.[22] The cost per participant moving into work was estimated at £1,388.

In addition to the New Deal, the government has taken steps to reform the way that benefits are delivered to claimants. In particular, it is piloting ONE, a system where all benefit claimants – not just the unemployed – are given a personal adviser and must attend work-focused interviews at regular intervals. This represents a middle way between the voluntary and compulsory New Deals, as claimants are obliged to attend interviews, where they will receive advice and support, but they are not compelled to seek and accept work, like participants on the compulsory New Deals. From April 2002, the requirement to attend interviews will be extended nationwide to all lone parents claiming income support with children over five.

## Prospects for the next Parliament

**The Labour Party** is proposing to extend and intensify the New Deal. The New Deals for young and older people will focus on numeracy, literacy, IT skills and presentation. All lone parents will be invited to interviews to discuss their employment options. Labour would also create a new agency – JobCentre Plus – by merging the Employment Service with those parts of the Benefits Agency that deal with people of working age.

**The Conservatives** would abolish the compulsory New Deals and replace them with a scheme called 'Britain Works'. This would effectively contract out the work of the Employment Service by paying independent contractors to help unemployed people find and retain jobs. This reform would be backed up by stronger conditions for those receiving jobseeker's allowance, making it harder or impossible for them to turn down job offers and continue to receive benefit. Although details of this policy are limited, it could be seen just as an extension of the present government's approach, where private and not-for-profit contractors are fully involved in the New Deal programme in some areas. The Tories are also proposing to abolish the voluntary New Deal for Lone Parents.

---

[21] J. Van Reenen, 'No more skivvy schemes? Active labour market policies and the British New Deal for Young People in context', Institute for Fiscal Studies, Working Paper no. 01/09, 2001, http://www.ifs.org.uk/workingpapers/wp0109.pdf. Other evaluations of the early stages of the New Deal can be found in B. Anderton, R. Riley and G. Young, *The New Deal for Young People: Early Findings from the Pathfinder Areas*, Employment Service, Sheffield, 1999, and in R. Layard, 'Welfare to work and the New Deal', *The Business Economist*, vol. 31, no. 3, pp. 28–40.

[22] J. Hales et al., *Evaluation of the New Deal for Lone Parents: Early Lessons from the Phase One Prototype – Synthesis Report*, Department of Social Security, London, 2000. Evaluation reports for the other New Deals can be found at http://www.employmentservice.gov.uk/english/about%5Fus/publications.asp.

The **Liberal Democrats** propose to replace the New Deal with a flexible guarantee of help for all out-of-work jobseekers, whether or not they are claiming jobseeker's allowance. It would be administered through a merged Benefits Agency and Employment Service. The Lib Dems would not introduce any more sanctions and would review the effectiveness of the existing ones.

*Mike Brewer*

# Appendix A

## Should we let people opt out of the basic state pension?

The UK pension system has been subject to almost continuous structural reform since the Social Security Act of 1975 introduced, from 1978, the State Earnings-Related Pension Scheme (SERPS). From 1980 until 1997, successive governments reduced the future generosity – and cost – of the state pension system. Since 1997, the government has increased the generosity of state commitments to the current generation of pensioners, the most significant change being the substantial increases in means-tested benefits for low-income pensioners.[1]

For future generations of pensioners, the Labour government has followed the general thrust of reform seen over the previous 20 years by expecting individuals to take more responsibility for their own pension savings through increased use of private pensions.[2] While the current generation of pensioners receive 40% of their income from private sources, the policy of the current Labour government is to aim for this to increase to 60% by 2050.[3] It is hoped that this can be achieved by continuing to target additional state resources at those on low incomes through the minimum income guarantee, the pension credit and the state second pension, while continuing to price-index the basic state pension. Middle and higher earners are increasingly being encouraged to make their own private pension provision, for example through the introduction of stakeholder pensions.

### The Conservative Party's proposals for the basic state pension

The Conservatives have proposed that this shift from state to private provision should go further. The Conservative Party manifesto states that

> 'The best way to achieve higher pensions in the future is by more genuine funding of pensions. We wish to enable young people to build up a funded alternative to the basic pension in the future'.

[1] Income support for pensioners, since renamed the minimum income guarantee, has been increased by up to 25% in real terms between April 1997 and April 2001. The current government is also proposing a new pension credit from April 2003, which will increase the amount of means-tested support to pensioners further still. For more details, see Chapter 10.

[2] For a detailed analysis of the reforms, see R. Disney, C. Emmerson and S. Tanner, *Partnership in Pensions: An Assessment*, Commentary No. 79, IFS, London, 1999, the executive summary of which is available at www.ifs.org.uk/pensions/partnership.shtml.

[3] Department of Social Security, *A New Contract in Welfare: Partnership in Pensions*, Cm. 4719, DSS, London, 1998 (www.dss.gov.uk/publications/dss/1998/pengp/index.htm). It is, as yet, unclear whether this aim has been changed due to the planned introduction of the pension credit in April 2003, which represents a further increase in means-tested state support for pensioners.

If implemented, this policy would allow younger individuals to choose between retaining their entitlement to the basic state pension or forgoing entitlement in return for lower National Insurance contributions. This is very similar to the way in which individuals who earn above the lower earnings limit are currently able to opt out of SERPS entitlement in return for the payment of a National Insurance (NI) rebate into their own private pension by the Department of Social Security.

## What are the cost implications of this proposal?

It is clear that, in both the short and the medium run, this policy would have a net cost to the government, since National Insurance contributions would decline but pension expenditure would be unaffected until some time in the future. The cost would depend on the generosity of the rebate, which would have to be generous enough to ensure some choose to opt out of the basic state pension. A person currently aged 20 who expected to receive the basic state pension for 15 years in retirement might be expected to require a National Insurance rebate of around £10 a week for them to choose to forgo their pension entitlement.[4] Older individuals would require a higher level of rebate, since they have fewer years until retirement to build a fund sufficient to replace their forgone basic state pension entitlement.

If the Conservatives chose to set a relatively generous level of rebate, it is possible that large numbers of individuals would choose to opt out of the basic state pension. For example, when individuals were first allowed to opt out of SERPS into a personal pension in 1988, the rebates offered were very generous compared with the amount of SERPS that these people were forgoing, particularly for younger people. This led to a higher-than-expected number of people taking out personal pensions at greater cost than had been anticipated by the government at the time.[5] The cost of reduced National Insurance contributions, after netting off the reduced entitlements to SERPS, was £5.9bn for the period from 1988 to 1993.[6]

Whether or not the Conservative policy implies a long-run net cost to the government depends on the expectations that young people have about how generous the basic state pension will be when they reach retirement. This is because of the voluntary nature of the contracting-out arrangements – only those individuals who believe that the NI rebate is worth more to them than their future pension entitlement would choose to opt out.[7] If young people

[4] This example assumes that the person knows with certainty that the basic state pension will be indexed in line with prices and that they are able to receive a real return of 3% a year on their NI rebate. Future pension entitlements are also discounted by 3% a year.

[5] For more details, see R. Disney and E. Whitehouse, *The Personal Pensions Stampede*, IFS, London, 1992.

[6] For more details, see A. Budd and N. Campbell, 'The roles of public and private sectors in the UK pension system', in M. Feldstein (ed.), *Privatizing Social Security*, National Bureau of Economic Research, Chicago University Press, Chicago, 1998.

[7] A more detailed explanation of this in the context of individuals opting out of SERPS is contained in R. Disney, C. Emmerson and M. Wakefield, 'Pension reform and saving in Britain', *Oxford Review of Economic Policy*, vol. 17, no. 1, forthcoming 2001.

believe that the state will be at least as generous as implied by current government policy, then the Conservative policy would have a long-run net cost to the government. There is evidence, though, that young people believe that the state will be less generous than is implied by current government policy.[8] If this does turn out to be the case, then it is possible that the Conservative policy would not have a long-run net cost to the public finances, since it might be possible to encourage people to opt out of their entitlement for a relatively low level of NI rebate.[9]

## Other issues

There are several arguments for and against the Conservatives' proposal. We now address some of these in turn.

### *Reduced future government expenditure*

The Tories' proposal would lead to lower expenditure once individuals who have opted out of the basic state pension reach retirement age. As discussed above, the voluntary nature of the reform makes it unclear whether the reform would lead to a long-run net cost or net benefit to the public finances.

### *Increased individual choice*

The Conservatives' proposal might be justified as allowing individuals greater freedom from the state, since they would be able to choose how they want to invest their NI rebate. This, in fact, was one of the arguments put forward for the introduction of personal pensions – the 1985 Social Security Green Paper stated that 'The Government wish to encourage the freedom and individual choice which personal pensions allow'.[10] The Conservative proposal would allow individuals to choose how they want to invest the NI rebate that replaces their entitlement to the basic state pension, in the same way that individuals can already choose how to invest the rebate that compensates those who have 'opted out' of SERPS.

Whether this increase in individual choice is seen as desirable depends, in part, on attitudes towards the increased levels of risk taken on by individuals who opt out. In addition, there is the potential problem of individuals whose investments fail to deliver sufficient levels of return falling back onto state support in the form of means-tested benefits in their retirement. It is the near

---

[8] See S. Tanner, *The Role of Information in Savings Decisions*, Briefing Note no. 7, IFS, London, 2000 (www.ifs.org.uk/publications/briefnotes.shtml).

[9] In fact, the main difference between the current Conservatives' proposal and the 'basic pension plus' proposal that they put forward prior to the May 1997 election is that, under basic pension plus, contracting-out among new entrants to the labour market would be mandatory. This has the advantage that it is possible to guarantee that, in the long run, the reform will not have a net cost to the government to implement, and it is the route that has been taken by many other countries. For a discussion of the reforms made elsewhere, see R. Disney, R. Palacios and E. Whitehouse, 'Individual choice of pension arrangement as a pension reform strategy', IFS, Working Paper no. W99/18, 1999, (www.ifs.org.uk/workingpapers/wp9918.pdf).

[10] Department of Social Security, *Reform of Social Security: Programme for Change*, Cmnd 9518, HMSO, London, 1985.

universality of the basic state pension that, at least partially, mitigates these problems. There are also arguments in favour of universal social insurance, since, if individuals are allowed to opt out of the basic state pension, many people may expect that they would never receive a National Insurance benefit at any point in their lives – which could potentially reduce support for the basic state pension in future.

***Increased levels of certainty over future pensions***

Another argument made in favour of greater levels of funding is that state pension entitlements are uncertain, since future governments may reduce the generosity of state schemes. For example, as a result of the reforms made to SERPS in the Social Security Acts of 1986 and 1995, forecast expenditure in 2030 is just 30% of what it would have been under the original SERPS arrangements. But funds held in private pensions can also be affected by the decisions made by future governments. For example, the July 1997 Budget decision to abolish the payment of dividend tax credits on private pension funds increased the tax liability of dividends received by pension funds by over £5bn a year.

***Higher return from increased holding of equities***

The return on equities has, at least historically, been higher than both the return on government bonds and that which is likely in a pay-as-you-go pension such as the basic state pension. This means that individuals who choose to invest in portfolios containing a high equity element would expect to end up with a higher retirement income. It is important to note that at least part of the reason why equities have had higher returns in the past is that they are considered relatively risky investments. Hence part of any additional return that individuals received would simply reflect a more risky investment portfolio. There is also some evidence that the rate of return on equities has been higher than it should have been, even given the higher risk involved.[11] It is by no means certain whether this can be expected to persist into the future – and if it did, it would suggest that the financial markets operate on a far from efficient way. If we could be sure that these higher expected equity returns were going to materialise, then the government could itself finance any of its future public spending plans by increasing government debt and investing in equities. There need to be very strong justifications for governments to invest in the markets on behalf of society. This is very similar to arguments regarding the Conservatives' proposals to reduce public expenditure by setting up endowment funds for universities, which is discussed in Section 8.10.

***Increased levels of national savings***

It has also been argued that higher levels of funding would lead to higher levels of saving and hence investment. This is not necessarily the case, since it is not clear whether the proposed reform would make individuals save more or less – for example, an individual who already has a personal pension would unambiguously save less as a result of this reform. This is because they can only be expected to opt out of the basic state pension if doing so provides

[11] See R. Mehra and E. C. Prescott, 'The equity premium: a puzzle', *Journal of Monetary Economics*, vol. 15, pp. 145–62, 1985.

them with an increase in their expected retirement income, which would reduce the amount that they need to save for their retirement. The addition to their pension fund from the NI rebate should not be counted as additional saving, since it comes directly from a reduction in government saving.[12] International capital flows reduce the likelihood that increased saving would lead to increased levels of domestic investment.

## Conclusion

Moving towards greater levels of funding does not avoid the problems caused by an ageing population. The incomes of pensioners in the future will have to come from future income, regardless of whether this is financed through a combination of pay-as-you-go and funded pensions savings or through entirely private pension savings. The rate of return offered by a pay-as-you-go pension scheme will fall when the population is ageing, since the contributions charged on the smaller working population have to rise to pay for the pensions of the larger retired population. But there is also uncertainty over the returns that equities and annuities will offer in the future. For example, it is possible that these will be affected by greater amounts of world-wide private pension saving and an ageing world population. Given that individuals should hold balanced portfolios, it seems sensible that a portion of future state pension provision should be funded on a pay-as-you-go basis.

*Carl Emmerson*

[12] Again, a more detailed explanation of this in the context of individuals opting out of SERPS is contained in R. Disney, C. Emmerson and M. Wakefield, 'Pension reform and saving in Britain', *Oxford Review of Economic Policy*, vol. 17, no. 1, forthcoming 2001.

# Appendix B[1]

## Public spending: What are the options beyond March 2004?

The Labour party's manifesto only contains details of public expenditure plans to the financial year 2003–04. The Conservative's manifesto commits them to spending £8bn less than Labours plans in that year, and says that, "We will be a tax-cutting government". Whoever wins the next election might well have to make choices about public spending and taxation in both 2004–05 and 2005–06. Higher growth in public spending would be likely to facilitate improvement in the quality of public services while lower growth in public spending would be likely to allow lower levels of taxes as a share of national income.

This short note outlines some possible scenarios for the path of public spending beyond March 2004. If Labour were to be re-elected, and their plans for public spending met, then spending would be 40.3% of national income in 2003–04. Whoever was the government at that point would have to decide what level of spending growth should continue beyond that point. If spending were to increase in line with growth in national income then, for a given level of public borrowing, taxes would need also to be kept constant as a share of national income. If total spending were to grow by less than growth in national income then some reductions in the tax take as a share of national income would be possible without increasing public borrowing. Figures for this are shown in table 1 and assume 2.5% real annual growth in national income. Under this assumption spending growth of 2% a year in real terms would allow reductions in tax as a share of national income of £2bn a year. Alternatively spending could be increased more quickly than national income. Again assuming 2.5% growth in national income increases in spending of 3.3%, which is the same increase as planned in the last spending review, would require increases in taxes as a share of national income of £3bn a year for borrowing to be left unchanged.[2]

The chosen growth in public spending beyond 2003–04 is likely to have implications for the quality of public services. Both Labour and the Conservatives have pledged to large real increases in spending on the NHS and on education between April 2001 and March 2004 of 5.7% and 5.6% a year in real terms respectively. It is, as yet, unknown whether the main political parties believe that these increases in spending should persist beyond March 2004. In addition we do not know what plans they have for social security spending. Under Labours' plans for public spending this is forecast to

[1] This additional section was not part of the printed version of this Commentary.

[2] For more details see HM Treasury (2000), *Spending Review 2000*, London: The Stationary Office, Cm. 4807 (http://www.hm-treasury.gov.uk/sr2000/index.html).

grow at 2.2% a year in real terms over the next three years, significantly below the 4.1% growth seen on average from 1950–51 to 1999–2000.[3]

Both main parties have stressed the need for large real increases in spending on the NHS (5.7% per year) and education (5.6% per year) over the next three years. This makes it interesting to consider what would happen if this growth were to continue beyond that point. The fiscal implications of this happening would in large part depend on what happens to the path of social security spending. Social security spending is forecast to grow by 2.2% a year in real terms over the next three years. On the basis of Labours' spending plans growth in spending on these three areas is forecast to be 4.0% a year in real terms over the next three years; constituting nearly 60% of government spending. For the purpose of this illustrative exercise we assume that growth in these three areas continues at this rate beyond 2003–04.

Table 1 shows that if total spending growth is to remain in line with the expected growth in national income then our scenario implies growth of just 0.6% a year in the remaining 40% of government. If overall spending were to grow more slowly than this, then such 'other' spending would likely be cut. Higher growth in total public spending of 3.3% a year would allow the large increases in spending on the NHS, education and social security to continue while growth in other areas of public spending would be likely to be able to grow by 2.4% a year in real terms.

**Table 1. A menu of options for the next Government.**

| Growth in total spending from 2003–04 onwards | Spending as % of GDP in 2005–06 | Resulting tax increase, £bn / year from 2004–05 onwards | Assumed growth in NHS, education and social security spending | Growth in spending on other areas |
|---|---|---|---|---|
| 1.0 | 39.2 | –6 | 4.0 | –3.0 |
| 2.0 | 39.9 | –2 | 4.0 | –0.6 |
| 2.5 | 40.3 | 0 | 4.0 | 0.6 |
| 3.3 | 41.0 | 3 | 4.0 | 2.4 |
| 3.8 | 41.4 | 5 | 4.0 | 3.6 |

Note: Assumes GDP growth of 2½ percent a year. £bn figures in 2000–01 prices. Growth in NHS, education and social security spending assumed to remain at the growth forecast over the next three years. Social security spending includes spending on the working families tax credit and the disabled persons tax credit.

In the examples outlined above we have assumed that social security spending only grows at 2.2% a year in real terms. Historically it has grown faster than this – for example over the 18 years of Conservative government from 1979 to 1997 it grew by an average of 3.6% a year in real terms. Higher growth in social security spending would make it harder to achieve any of the scenarios outlined above, and it is worth noting that the Labour party's commitment to a pension credit, integrated child credit and employment tax credit are not yet included planned spending. We have also not taken into account any other objectives that the next government may have – for example if the goal of

[3] Source: Emmerson, C. and Leicester, A. (2000), *A survey of the UK benefit system*, Briefing Note No. 13, London: IFS (http://www.ifs.org.uk/taxsystem/contents.shtml).

abolishing child poverty is to be met then this is likely to require ongoing real increases in the generosity of some transfer payments.

It will always be the case that, for a given level of public borrowing, higher or lower levels of public spending as a share of national income imply higher or lower levels of taxes. While we do not expect political parties to publish detailed spending proposals for the whole of the next parliament indications of the desired growth in spending on key services such as the NHS and education would certainly be informative. Similarly if parties propose lower growth in spending then they should state in which areas of public spending they believe lower growth should occur.

*Tom Clark and Carl Emmerson*