7. Tax and welfare reforms planned for 2013–14[1]

Robert Joyce and David Phillips (IFS)

Summary

- Tax and welfare reforms in 2013–14 will amount to a small net 'giveaway' in aggregate, at an average of about £33 per household (£0.9 billion in total) in that year. This may come as a surprise, as these changes are taking place in the context of efforts to reduce the budget deficit substantially. However, tax and benefit measures implemented since April 2010 as a whole do represent a significant net 'takeaway' of £1,360 per household (£35.9 billion in total).

- The 2013–14 reforms comprise a £6.2 billion gross giveaway mostly offset by a £5.3 billion gross takeaway. The gross giveaway is mostly accounted for by tax cuts, with a large increase in the income tax personal allowance being the most substantial. The gross takeaway is accounted for by various welfare cuts and some small tax rises. Overall, tax measures amount to a net giveaway of £4.2 billion and welfare measures amount to a net takeaway of £3.4 billion. This broad pattern of tax giveaways and welfare takeaways means that the changes, on average, reduce net incomes towards the bottom of the income distribution and increase net incomes in the middle and upper parts of the distribution.

- This set of changes should be seen in the context of a whole raft of reforms implemented, or to be implemented, as part of the fiscal consolidation plan. Up to 2015–16, those at the very top of the income distribution will have tended to lose the most, by some distance, from tax and benefit changes introduced since 2010. Those on working-age benefits, found predominantly towards the bottom of the income distribution, will have been hit the next hardest. Households in the middle and upper-middle will have tended to lose less than other groups, in no small part because they are the biggest gainers from the substantial increases to the income tax personal allowance. However, those on middle and higher incomes have been most squeezed by the failure of earnings to grow in real terms, and this is forecast to continue in 2013–14.

- In terms of the structural changes to the tax and welfare system, the government's record is mixed. On the welfare side, Universal Credit will shortly start to replace six means-tested benefits and tax credits with a single integrated benefit. This could constitute a welcome simplification and remove some of the weakest incentives to work faced by claimants under the current system. But the localisation of Council Tax Benefit, also taking effect in 2013–14, may well undermine some of these advantages.

- The government has clear strategies both in relation to income tax for individuals on low incomes and for corporation tax, and has stuck to them. Elsewhere, a clear tax strategy is lacking. Perhaps the prime example is fuel duties, for which policy has been set in a haphazard way by repeatedly delaying (and eventually cancelling) annual cash-terms uprating that would otherwise have kept their level constant in real terms.

[1] The Green Budget 2013 is funded by the Nuffield Foundation

- A more careful and systematic statement of how things should be indexed would also be welcome. Indexation policy matters hugely for the future shape of the tax and benefit system and the public finances. A change in April will mean that future Local Housing Allowance rates – which set the maximum rents against which private sector tenants can claim Housing Benefit – will depend upon historical local rent levels but not current ones. This is difficult to square with any intelligible policy objective. And the government's recent comments on relative patterns of benefits and earnings growth suggest that it may not view straightforward price indexation of most benefit rates – the current default assumption – as the appropriate rule. An explicit statement of what it thinks *is* appropriate in the long run is needed.

7.1 Introduction

The coming fiscal year, 2013–14, is the fourth successive year of substantial tax and welfare changes, aimed in part at contributing to the government's efforts to reduce the structural budget deficit. Approximately 15% of the reduction in government borrowing by 2017–18 is planned to come from tax increases, and a further 16% from welfare cuts (the remaining 69% of the fiscal consolidation is planned to be accomplished via other spending cuts).[2]

Perhaps surprisingly, then, the tax and welfare reforms taking effect in fiscal year 2013–14 are estimated to amount to a modest net 'giveaway' in aggregate of about £0.9 billion in that year, or an average of about £33 per household.[3] Including a number of changes introduced in January 2013 (which are therefore not included in the above figures for reforms taking effect in 2013–14),[4] this brings the total tax and welfare net takeaway since April 2010 to £35.9 billion, or £1,360 per household, in 2013–14.[5]

The aggregate figures are the result of many specific policy changes. In 2013–14, the average net giveaway of £33 per household comprises a £234 gross giveaway offset by a £201 gross takeaway. Households may lose and gain from different reforms, leading to a complex pattern of winners and losers across the population. The giveaway is largely accounted for by tax cuts, mostly of the same form that we have already seen during this parliament. There are real cuts to income tax (the personal allowance and the rate of income tax on incomes over £150,000), fuel duties, council tax, and the main rate of corporation tax. The takeaway is made up primarily of cuts to the welfare budget. Overall, tax measures amount to a net giveaway of £4.2 billion and welfare measures amount to a net takeaway of £3.4 billion.

All taxes are ultimately incident on households. For example, although corporation tax is formally 'paid by companies', it must eventually be borne by households as consumers, employees or shareholders. But the focus of this chapter is mostly on personal taxes – such as income tax and fuel duties – which tend to have immediate and measurable effects on more readily identifiable groups of households, rather than changes to

[2] See Chapter 5 of this Green Budget.

[3] The number of households is estimated at 26.4 million in 2012. Source: http://www.ons.gov.uk/ons/rel/family-demography/families-and-households/2012/stb-families-households.html.

[4] These changes include the tapering away of Child Benefit for families where at least one adult has a taxable income of more than £50,000 per year, and an increase in the bank levy.

[5] Cash-terms estimate of the impact of tax and benefit policy measures in 2013–14, based upon policy costings listed in various Budget documents since 2009.

corporation tax, the carbon price floor and so on. The overall net giveaway of £0.9 billion from tax and benefit reforms in 2013–14 is made up of a £0.4 billion (or £16 per household) net giveaway in household taxes, social security and tax credits and a £0.4 billion (or £16 per household) net giveaway in business and other taxes.

The chapter proceeds as follows. Section 7.2 provides an overview of all reforms to the tax and benefit system coming into effect in 2013–14, alongside their consequences for the public finances in 2013–14 and the longer run. Section 7.3 analyses in more detail the specific changes to personal direct and indirect taxes, and Section 7.4 looks in more detail at the changes to the welfare system. Overall distributional analysis of the changes to personal direct and indirect taxes and welfare is presented in Section 7.5. Section 7.6 summarises and concludes.

7.2 Overview of tax and welfare changes in 2013–14

Table 7.1 lists the changes to the tax and benefit system to be implemented in 2013–14, separately by category of reform. It shows the estimated revenue effects in both 2013–14 and the longer run when the changes are fully in place. All of the reforms will ultimately affect households, but those in italics are excluded from the distributional analysis in Section 7.5, as they cannot be robustly attributed to particular groups of households precisely enough with the data available. It should be borne in mind that changes in spending on public services will also affect households, but the focus of this chapter is on taxation, cash benefits and tax credits, rather than benefits in kind which again are difficult to attribute to particular households.

The table shows that there is to be an annual net ‘giveaway’ of about £0.9 billion from tax and benefit reforms introduced in 2013–14, rising to about £1.4 billion in the longer run as the effects of the changes are fully felt (see the note to the table for how the longer-run impact is calculated). This comprises a gross giveaway of about £6.2 billion and a gross takeaway of about £5.3 billion (rising to £8.3 billion and £7.0 billion, respectively, once the changes introduced in 2013–14 are fully felt).

The largest giveaway is the substantial increase in the income tax personal allowance for those aged under 65. Net of the concurrent reduction to the higher-rate threshold – the point at which the higher marginal income tax rate starts to be paid – that acts to limit the gain to higher-rate taxpayers, the change costs £4.0 billion in 2013–14. Considered alongside increases in the personal allowance in April 2011 and April 2012, this means that about 1.5 million fewer individuals will pay income tax in 2013–14 than if the current government had just used the uprating defaults that it inherited.[6] It takes the cost of all the government’s changes to the personal allowance and associated reductions to the higher-rate threshold to £9.0 billion per year.[7] Cuts to the higher-rate threshold mean that there are 1.6 million more higher-rate taxpayers than there would have been had the higher-rate threshold been uprated in line with RPI inflation since 2010–11.[8]

[6] Source: authors’ calculations using the 2010–11 Family Resources Survey and TAXBEN, the IFS tax and benefit microsimulation model.

[7] This is the sum of the costings given in the ‘2013–14’ columns of table 2.2 of the March 2011 Budget (http://cdn.hm-treasury.gov.uk/2011budget_complete.pdf); tables 2.1 and 2.2 of the March 2012 Budget (http://cdn.hm-treasury.gov.uk/budget2012_complete.pdf); and table 2.1 of the 2012 Autumn Statement (http://cdn.hm-treasury.gov.uk/autumn_statement_2012_complete.pdf).

[8] Source: authors’ calculations using the 2010–11 Family Resources Survey and TAXBEN, the IFS tax and benefit microsimulation model.

Table 7.1. Estimated revenue effects of tax, benefit and tax credit changes to be introduced in 2013–14

	2013–14 estimated revenue effect (£ million)	Long-run estimated revenue effect (£ million)
Personal direct taxes	**–3,320**	**–2,950**
Increase personal allowance by £1,115 above indexation to £9,440 and reduce basic-rate limit, upper earnings limit and upper profits limit by £2,360 in cash terms	–3,990	–3,920[a]
Freeze age-related personal allowances in cash terms and restrict to existing beneficiaries	+360	+360[b]
Reduce additional marginal income tax rate from 50% to 45% on income above £150,000	–50	–100[a]
CPI-index some National Insurance thresholds	+135	+135[b]
Reform taxation of non-domiciled residents	+110	+50[c]
Company car tax rate changes	+115	+115
Introduce a cap on certain tax reliefs	0	+410[a]
Other personal taxes and indirect taxes	**+225**	**+945**
Funding for council tax freeze[d]	–270	0[c]
Postpone fuel duties uprating to September	–410	0[a]
Tobacco duty escalator	+50	+50[b]
Alcohol duty escalator	+125	+125[b]
Increase landfill tax by £8 per tonne	+80	+80
Introduce a carbon price floor	+615	+615
Freeze inheritance tax threshold	+35	+75[a,b]
Corporation tax and other taxes	**–1,130**	**–1,765**
Reduce main corporation tax rate to 23%	–390	–750[a]
Introduce corporation tax Patent Box	–350	–910[c]
Various other tax changes ('giveaways')	–550	–360[a,c]
Various other tax changes ('takeaways')	+160	+255[a,c]
Benefits and tax credits	**+3,355**	**+2,380**
CPI-index most benefits and tax credits	+425	+425[b]
Increase working-age benefits and tax credits by nominal 1%	+505	+505[b]
Increase Basic State Pension by highest of earnings growth, CPI inflation and 2.5%	+80	+80[b]
Freeze Child Benefit	+270	+270
Disability Living Allowance: reform gateway from 2013–14 (introduction of Personal Independence Payment, PIP)	+345	+1,495[c]
Cut Housing Benefit entitlement for underoccupying working-age social sector tenants	+490	+490

	2013–14 estimated revenue effect (£ million)	Long-run estimated revenue effect (£ million)
Uprating of Local Housing Allowance rates capped by CPI inflation	+90	+90[b]
Introduce benefits cap	+275	+275
Reduce Pension Credit Savings Credit in cash terms	+105	+105[b]
Increase Pension Credit Guarantee Credit by same cash amount as Basic State Pension	–70	–70
Freeze basic and 30-hour elements of Working Tax Credit in cash terms	+180	+180
Introduce Universal Credit	+70	–2,230[c]
Tax credits: reduce disregard for in-year rises in income from £10,000 to £5,000	+200	+280[a]
Localise Council Tax Benefit and reduce expenditure by 10%[e]	+485	+485
Extend support for mortgage interest	–95	0[c]
Gross 'giveaway'	–6,175	–8,340
Gross 'takeaway'	+5,305	+6,950
Grand total	–870	–1,390
Of which:		
Tax	–4,225	–3,770
Welfare	+3,355	+2,380
Personal taxes and welfare	–435	–320
Business and other taxes	–435	–1,070

[a] Estimated revenue effects in 2014–15.

[b] These reforms involve a departure from or a change to default uprating in years after 2013–14. However, the revenue effects included in the table are for the departure/change in 2013–14 only, isolating the impact of the reform in that year.

[c] Estimated revenue effects in 2015–16 (reform taxation of non-domiciles; extension of support for mortgage interest; funding for the council tax freeze), 2016–17 (replacement of DLA with PIP; the Patent Box) or 2017–18 (introduction of Universal Credit; changes to business rates included within 'various other tax changes').

[d] These figures refer to the £270 million per year for two years that the UK government will provide to local authorities that freeze council tax in 2013–14. This is equivalent to approximately 1% of current council tax revenues in England. It is not yet clear how many local authorities will take up this offer or what the increase in council tax would be in the absence of this policy. The distributional analysis in Section 7.5 assumes all councils take up this offer and would have increased council tax by 2.9% in the absence of this policy.

[e] These figures refer to the planned cut in grants to local government and the Welsh and Scottish governments to pay for council tax rebates for low-income households. In practice, councils may choose to cut support by more or less than this amount. Section 7.4 provides details. The distributional analysis in Section 7.5 assumes that support remains at the same level as currently in Scotland and England and that Wales implements its announced plans. For systems where Universal Credit is in place, the default council tax support scheme is assumed.

Notes: This table includes tax and benefit changes taking effect in fiscal year 2013–14; revenue estimates relate only to those reforms. Three significant changes took effect in January 2013 and are excluded from the table: the tapering away of Child Benefit for families where at least one adult has a taxable income of more than £50,000 per year; a temporary increase in the corporation tax annual investment allowance; and an increase in the bank levy. We also exclude revenues from the tax deal with Switzerland, a large part of which will be paid in 2013–14. We count as a reform any change to tax or benefit rules or parameters and any departure from the default uprating rules as of January 2010. Reforms that were announced but subsequently modified appear only once, in their modified form. For reforms announced before the Autumn Statement 2012, the most recently published Treasury revenue estimates were based on OBR economic forecasts that have now been superseded – where possible, the estimates here have been adjusted in an attempt to account for this.

Notes continue

Table 7.1 Notes continued
HM Treasury's policy change scorecard reports revenues on a cash receipts basis, as opposed to an accruals basis. This means that the full effect of some reforms in 2013–14 – such as those to corporation tax and income tax for those on high incomes – are only picked up in the 2014–15 costings. In this instance, the 'long-run' effects are stated as the 2014–15 costing (see note a). If a policy change is temporary and has only short-run revenue implications, the 'long-run' revenue effect is recorded as 0. For policy changes that take several years to be fully felt or rolled out – such as Universal Credit – the long-run effect is taken from the year in which the policy is fully rolled out (see note c). Note, however, that when showing the public finance implications of changes in tax and benefit uprating rules, we show the effect of the change in uprating in 2013–14 only (i.e. the further effects of changes in indexation in subsequent years are *not* included in the 'long-run' effect) (see note b).
Source: Chapter 2 and policy costings documents of HM Treasury, *Budget 2010* (June), *Budget 2011* and *Budget 2012* (http://www.hm-treasury.gov.uk/budget.htm); chapter 2 and policy costings documents of HM Treasury, *Autumn Statement 2011* (http://www.hm-treasury.gov.uk/as2011_index.htm) and *Autumn Statement 2012* (http://www.hm-treasury.gov.uk/as2012_index.htm); HMRC, 'Direct effects of illustrative changes' (http://www.hmrc.gov.uk/statistics/expenditures/table1-6.pdf); DWP's July 2012 Impact Assessment of the Benefits Cap (http://www.dwp.gov.uk/docs/benefit-cap-wr2011-ia.pdf); and authors' calculations using the Family Resources Survey 2010–11 and the IFS tax and benefit microsimulation model, TAXBEN. Note that some small changes to policy have been made since the latest costings were produced (for example, the roll-out of the benefits cap will be slightly slower than initially expected); the revenue implications of these changes are expected to be small.

Another substantial cut in income tax is the reduction in the additional rate of income tax on incomes of over £150,000 per year, from 50% to 45%. However, because the Treasury expects significant behavioural response (for example, greater work effort, and less tax evasion and avoidance), the official estimate of the cost to the exchequer is just £50 million in 2013–14 and £100 million per year in the longer run.

There are other modest rises in personal direct taxes in 2013–14, but they offset the large tax cuts only partially: overall, changes to income tax, National Insurance contributions and company car tax are expected to cost the Treasury £3.3 billion in 2013–14 (falling to £3.0 billion in the longer run).

Changes to other personal taxes and indirect taxes are, on average, a net takeaway: a postponement of increases in fuel duties is more than offset by higher tobacco and alcohol duties, higher landfill tax, the introduction of a carbon price floor, and a cash-terms freeze in the inheritance tax threshold. Changes to corporation tax and other taxes are a net giveaway, costing the Treasury £1.1 billion in 2013–14 (rising to £1.8 billion in the longer run), with cuts in the main rate of corporation tax and the introduction of the 'Patent Box' accounting for most of this.

Most of the takeaways in 2013–14 take the form of cuts to working-age benefits and tax credits. The most significant in revenue terms are changes to the amount by which benefits and tax credits are uprated, the cuts to funding for council tax support, and cuts to Housing Benefit for those deemed to underoccupy social housing. In the longer run, the reassessment of Disability Living Allowance (DLA) claimants and the replacement of DLA by the Personal Independence Payment are set to raise £1.5 billion per year by 2016–17. However, not all changes to benefits and tax credits are takeaways. The year 2013–14 also sees the start of the roll-out of Universal Credit, which, although expected to raise £70 million in 2013–14, is expected to cost around £2.2 billion a year when fully rolled out in 2017–18.

Overall, tax measures taking effect in 2013–14 are expected to cost the exchequer about £4.2 billion in that year, falling to about £3.8 billion in the long run. Changes to benefits and tax credits taking effect in 2013–14 are expected to raise £3.4 billion in that year, falling to £2.4 billion in the longer term as the changes to DLA and Universal Credit are rolled out fully.

7.3 Personal tax reforms

We now turn to the details of the reforms to personal taxes listed in Table 7.1. Some of the changes continue the pattern set by earlier reforms in this parliament, including a further rise in the income tax personal allowance for those aged under 65 and further real cuts to fuel duties and council tax. But there are other changes too, including a cut to the additional marginal income tax rate and the phasing-out of age-related personal income tax allowances. This section analyses the consequences of these reforms for the incomes, incentives and behaviour of those affected.

Increase to income tax personal allowance for under-65s, and associated changes to higher-rate threshold

The income tax personal allowance for those aged under 65 will rise from £8,105 per year to £9,440 per year in April 2013.[9] This is a discretionary increase of £1,115 over and above default RPI indexation, and translates into an annual cash gain of £223 for basic-rate taxpayers.[10] Combined with simultaneous changes to the higher-rate threshold that act to restrict the gains to higher-rate taxpayers to just £8.50 per year (see below), the measure costs about £4.0 billion in 2013–14.[11] The government's goal of a £10,000 personal allowance will now be reached in April 2015 simply as a result of RPI indexation in April 2014 and April 2015, unless inflation undershoots the Office for Budget Responsibility's (OBR's) forecasts.

This latest discretionary increase in the personal allowance should be viewed in the context of previous substantial above-RPI increases in April 2011 and April 2012. The cumulative impact is for the personal allowance to be £2,095 higher in April 2013 than it would have been under the uprating defaults that this government inherited. Individuals under 65 who face the basic marginal rate of income tax in 2013–14 will be £419 per year better off than they would have been without all these changes. A further 1.5 million individuals who would have paid some income tax in 2013–14 in the absence of these changes will not pay any,[12] and will therefore also gain, although by less than £419 per year.

At the same time, the higher-rate threshold – the point at which the marginal income tax rate rises from 20% to 40% – is being reduced by £1,025 in cash terms. The upper earnings limit – the point at which the marginal rate of employee National Insurance

[9] Note that this personal allowance also applies to individuals aged 65 or over if their taxable income exceeds (as of April 2013) £28,220 per year, because additional age-related allowances are tapered away as income rises above (as of April 2013) £26,100. We estimate that this will apply to about 9% of individuals aged 65 or over in 2013–14. For simplicity, we continue to simply refer to this personal allowance as the allowance 'for those aged under 65'.

[10] Unlike for benefits and tax credits, and certain National Insurance thresholds, RPI indexation (as opposed to CPI indexation) remains the default uprating policy for the personal allowance until it reaches £10,000 in cash terms.

[11] This is the sum of the costings for the increases in the personal allowance announced in the 2012 Budget and Autumn Statements, and the freeze in the basic-rate limit announced in the June 2010 Budget (see Table 7.1). The original sources are tables 2.1 and 2.2 of the March 2012 Budget (http://cdn.hm-treasury.gov.uk/budget2012_complete.pdf) and table 2.1 of the 2012 Autumn Statement (http://cdn.hm-treasury.gov.uk/autumn_statement_2012_complete.pdf).

[12] Source: authors' calculations using the 2010–11 Family Resources Survey and TAXBEN, the IFS tax and benefit microsimulation model. Relative to a baseline in which the incoming coalition government had also implemented the pre-announced £130 below-inflation rise in the personal allowance in April 2011, this number rises from 1.5 million to 1.6 million.

contributions falls from 12% to 2% – is sensibly being kept aligned with the higher-rate threshold. The combined effect of these income tax and National Insurance changes on earners who pay the higher rate of income tax is a gain of just £8.50 in 2013–14, relative to the default of RPI indexation.[13]

This continues the recent pattern of restricting the gains to higher-rate taxpayers (and hence the exchequer cost) from increases in the personal allowance.[14] The higher-rate threshold – that is, the point at which an individual starts to pay the higher marginal rate of income tax – will be £41,450 in 2013–14. Had it simply been uprated in line with the RPI since 2010–11, it would have been 20% higher, at £49,845, and there would have been an estimated 1.6 million fewer higher-rate income tax payers in 2013–14 as a result.[15,16] Note that, because the higher-rate threshold and the upper earnings limit have been kept aligned (see above), the effect has been to raise the combined income tax and employee National Insurance rate from 32% to 42% on income between £41,450 and £49,845.

By lowering the marginal income tax rate from 20% to 0% over a range of (low) income, increases in the personal allowance strengthen the financial incentive for low earners to work and for those with incomes no higher than the allowance to earn a little more (although it is important to note that for those also subject to the withdrawal of benefits and tax credits when entering work or increasing earnings, the strengthening of work incentives can be much more modest than the decline in headline income tax rates suggests). But they are also giveaways to every basic-rate taxpayer aged under 65 in the country, and this has two important consequences.

First, alongside the fact that the lowest-income families tend not to pay income tax anyway, it helps explain why, contrary to popular perception, the policy is not 'progressive'. The largest average gains – in cash terms and as a percentage of income – go to those in the middle and upper-middle of the income distribution. In particular, two-earner couples gain twice over. (This is, however, the most progressive way of cutting income tax.)

Second, increases in the personal allowance are expensive. Even net of the various adjustments to the higher-rate threshold that have been used to limit the gains to higher-rate taxpayers, the government's discretionary increases to the personal allowance in this parliament will cost the exchequer about £9.0 billion in 2013–14.[17]

---

[13] This does not apply to those with taxable incomes exceeding £100,000 per year, who lose overall from these changes. The personal allowance is gradually withdrawn as taxable income rises between £100,000 and £118,880, so individuals with incomes this high do not gain (or gain only partially) from increases to the personal allowance, but they lose from reductions to the higher-rate threshold.

[14] In fact, without any adjustment to the basic-rate limit, higher-rate taxpayers would gain twice as much in cash terms as basic-rate taxpayers from personal allowance increases. This is because the higher-rate threshold is not a tax parameter that is explicitly uprated – rather, it is simply the sum of the personal allowance and the basic-rate limit, which are each uprated individually. Therefore, an increase in the personal allowance in isolation increases the higher-rate threshold by the same amount. Without a corresponding adjustment to the basic-rate limit, the effect on higher-rate taxpayers is to save them 40% tax over a range of income (rather than 20% as for basic-rate taxpayers).

[15] Source: authors' calculations using the 2010–11 Family Resources Survey and TAXBEN, the IFS tax and benefit microsimulation model.

[16] The government also plans to increase the higher-rate threshold by 1% in cash terms – a further real cut, provided inflation exceeds 1% as currently forecast – in both April 2014 and April 2015.

[17] This is the sum of the costings given in the '2013–14' columns of table 2.2 of the March 2011 Budget (http://cdn.hm-treasury.gov.uk/2011budget_complete.pdf); tables 2.1 and 2.2 of the March 2012 Budget (http://cdn.hm-treasury.gov.uk/budget2012_complete.pdf); and table 2.1 of the 2012 Autumn Statement (http://cdn.hm-treasury.gov.uk/autumn_statement_2012_complete.pdf).

Income tax and National Insurance thresholds

The increases in the income tax personal allowance mean that a significant gap has opened up between the point at which people start paying income tax and the point at which they start paying National Insurance contributions (NICs). The primary threshold, at which employees start to pay NICs, will be £7,748 per year in 2013–14 – £1,692 less than the income tax allowance. There is therefore a small but growing range of income over which the combined income tax and NICs rate is 12% before rising to 32% when income tax becomes payable. We estimate that about 1.0 million individuals will therefore pay NICs but not income tax in 2013–14.[18]

The government could have spent the same revenue it has spent on raising the personal allowance in isolation on aligning the primary threshold and the personal allowance and then increasing both thresholds together. This alternative would have better served the government's aim to 'reward work', a stated objective of the policy:[19] because cuts to NICs do not affect tax paid on unearned income, the total tax cut on earned income could have been larger at the same total cost. And this would have cut taxes for an even lower-earning group than the government's policy. Treating both thresholds together would also have simplified the combined income tax and National Insurance marginal rate schedule. As it is, no earner has been taken out of the income tax and National Insurance system by the government's changes. This continues the trend of policymakers seemingly ignoring the fact that National Insurance contributions are a tax on earned incomes just as surely as is income tax.

Phasing-out of age-related income tax personal allowances

The second reform to income tax personal allowances is a takeaway rather than a giveaway. Currently, those aged at least 65 have a higher allowance: £10,500 per year for those aged 65 to 74 and £10,660 per year for those aged 75 or over. These additional age-related allowances will start to be phased out from April 2013. We estimate that about 3.6 million individuals (37% of those aged 65 or over) will pay more income tax in 2013–14 as a result, losing an average of £68 per year.[20]

First, the allowances will be frozen in cash terms from April 2013 until they are no higher than those for the under-65 population, at which point the additional age-related allowances will be abolished. Current policy for the under-65s' allowance, and the OBR's inflation forecasts, imply that the age-related allowances will therefore have been fully phased out by April 2019.[21]

---

[18] Source: authors' calculations using the 2010–11 Family Resources Survey and TAXBEN, the IFS tax and benefit microsimulation model.

[19] See paragraph entitled 'Policy objective' on page 1 of http://www.hmrc.gov.uk/budget2012/tiin-2044.pdf.

[20] Source: authors' calculations using the 2010–11 Family Resources Survey and TAXBEN, the IFS tax and benefit microsimulation model.

[21] This is based on forecasts of annual RPI inflation in the year to September in 2013 and 2014, and forecasts of annual CPI inflation in the year to September in 2015, 2016 and 2017. This is because current policy is for the indexation of the personal allowance for those aged under 65 to switch from RPI to CPI inflation once the allowance reaches £10,000 in nominal terms, which is set to happen in April 2015. Given these forecasts, the £10,500 allowance currently for those aged 65 to 74 will have been phased out fully by April 2018; and the £10,660 allowance currently for those aged at least 75 will have been phased out fully by April 2019, assuming CPI inflation in September 2018 of at least 0.1% (the OBR's forecast horizon means that its last forecast of September inflation is currently for 2017).

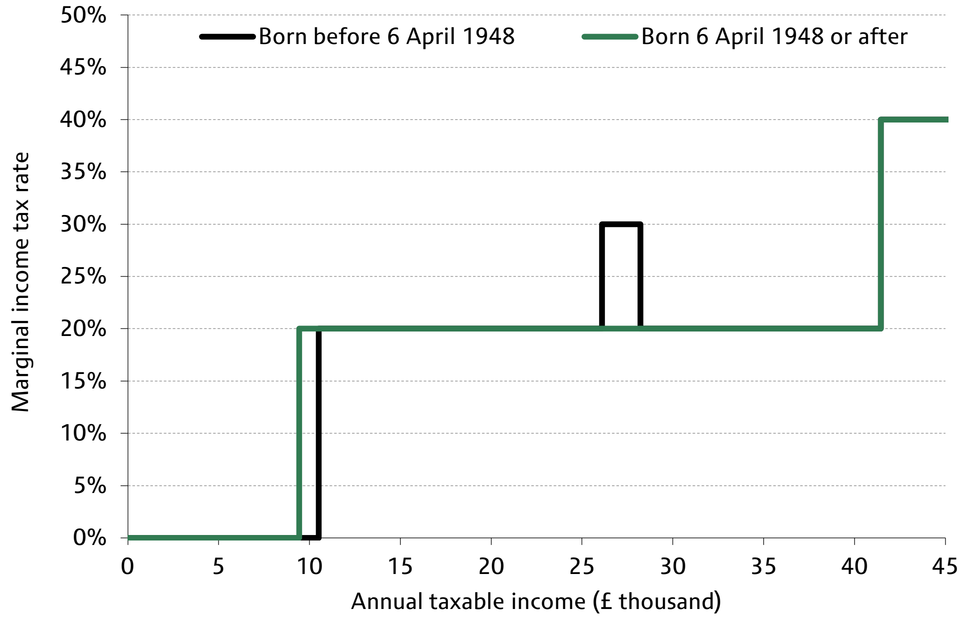
Second, from April 2013, the age-related allowances will be restricted to existing beneficiaries. This means that cohorts born on or after 6 April 1948 (i.e. turning 65 on or after 6 April 2013) will never get an additional age-related allowance.[22]

Neither the lowest-income nor the highest-income pensioners are affected. About 5.4 million individuals aged 65 or over (55% of the total) with relatively low taxable incomes would not have paid income tax in 2013–14 anyway; and a further 800,000 (9% of the total) would not have benefited from the additional age-related personal allowance because it is tapered away as annual taxable income rises above (as of April 2013) £26,100.[23]

For existing beneficiaries of the additional age-related allowances, the cash freeze increases liability to income tax in 2013–14 by up to £56 per year relative to the previous default of RPI indexation. The biggest cash losses, relative to previous policy, are for individuals who turn 65 *during* 2013–14 and who would, in the absence of this policy, have benefited in full from the additional age-related allowance[24] but instead will have the same allowance as those aged under 65. Those individuals will pay £268 per year (just over £5 per week) more in income tax than they would otherwise have done. Note that this loss is considerably less than it would have been without the substantial increases to the allowance for those currently aged under 65.

Because the allowance for those aged under 65 has recently increased so rapidly in real terms, the most obvious economic justification for giving pensioners higher personal

Figure 7.1. Marginal income tax rate schedule in 2013–14 for individuals born either side of 6 April 1948 (but on or after 6 April 1938)



Source: Authors' calculations.

[22] It also means that cohorts born between 6 April 1938 and 5 April 1948 inclusive will get an annual allowance of £10,500 rather than the £10,660 to which they would have become entitled when turning 75 in the absence of this policy change.

[23] Source: authors' calculations using the 2010–11 Family Resources Survey and TAXBEN, the IFS tax and benefit microsimulation model.

[24] Those with annual taxable income between £10,780 and £26,100.

allowances – to save those with modest levels of private income from having to interact with the income tax system and fill in self-assessment forms – has been weakening. And as well as simplifying the income tax system generally by harmonising the treatment of different age groups, the reform also simplifies pensioners' marginal income tax rate schedules, as shown by Figure 7.1. Those who benefit from the additional age-related allowances have 50p of the allowance withdrawn for every £1 by which taxable income exceeds a certain level (£26,100 in 2013–14), until their allowance is no higher than that for under-65s. This creates an odd 10 percentage point spike in the individual's marginal income tax rate,[25] and it does so in a way that lacks transparency. A welcome side effect of abolishing age-related allowances is the abolition of this confusing taper.

One can always debate the appropriate generosity of the system to different groups, given differing distributional objectives. But as a structural simplification of the tax system, this reform is sensible.

Cut in additional marginal income tax rate from 50% to 45%

The third significant change to income tax is the reduction in the additional marginal rate of income tax on incomes of over £150,000 from 50% to 45% in April 2013. This represents a significant cut in the tax rate for approximately the top 1% of income tax payers in the UK. It would, in the absence of any behavioural response, cost approximately £3.0 billion in 2013–14 (on an accruals basis), or around £10,000 per affected taxpayer. However, the OBR thinks that there will be substantial behavioural responses to the lower tax rate, including additional work effort and reduced avoidance and evasion activity, that act to reduce its post-response central estimate of the cost to just £80 million in 2013–14 (£50 million on a cash basis), rising to £100 million in the following few years.[26] As well as significantly reducing the cost of the policy to government, if at least part of the response takes the form of real increases in economic activity leading to more income (and hence more tax revenue) – rather than simply changes in tax avoidance and evasion – then the pre-tax incomes of affected individuals will increase. HM Revenue and Customs (HMRC), in its initial assessment of the impact of the current 50% additional rate, cites studies that 'suggest that between one-third and one-half of the response comes from genuine [changes] in … income'.[27]

The 50% tax rate was announced in Budget 2009 and introduced in April 2010. In the March 2010 Budget, it was predicted that the 50% rate would raise around £2.7 billion per year after accounting for behavioural response (compared with £6.5 billion before behavioural response). This was based on an assumption about the responsiveness of high-income individuals to taxation that was somewhat lower than found in previous UK and US studies of their behaviour. HMRC's initial assessment of the 50% tax rate – the first estimate based on evidence from the actual introduction of the 50% tax rate – found that the behavioural response was larger than that assumed by HM Treasury in 2010, and more in line with other studies. This suggested that the 50% rate was raising considerably less than initially anticipated, and was the basis for the updated behavioural assumptions used by HMRC and the OBR to calculate the cost of reducing the rate to 45%.

---

[25] Losing 50p of personal allowance costs 10p in additional tax, given the basic 20% rate of income tax.

[26] Costings taken from HMRC, 'The exchequer effect of the 50 per cent additional rate of income tax', March 2012 (http://www.hmrc.gov.uk/budget2012/excheq-income-tax-2042.pdf). Unless otherwise stated, figures cited in this subsection are taken from this document.

[27] Page 44 of HMRC, 'The exchequer effect of the 50 per cent additional rate of income tax'.

The estimates of responsiveness produced by the HMRC model are, however, very imprecise, and the cost of cutting the additional rate of tax to 45% is highly sensitive to how responsive people are. This means that there is considerable uncertainty around the central estimate that the reduction in the additional marginal rate from 50% to 45% costs £100 million per year: HMRC estimates that the policy would cost more like £800 million if people were as responsive as initially assumed by the Treasury or could raise around £700 million if they were just over a fifth more responsive than under the new central estimate.

So, much uncertainty remains over the revenue effects of cutting the 50p rate back to 45p. Several things are clear though. First, even on the Treasury's original assumptions, raising the top rate of tax to 50p would have had major behavioural effects. Second, HMRC's analysis quite clearly demonstrates significant amounts of behavioural change by affected individuals, and especially the shifting of incomes between years ('forestalling'). Such large distortions to behaviour are indicative of an economically inefficient tax and remind us that it is important not to fixate simply on how much the 50p rate raised (or cost) and how much the move back to 45p will cost (or raise). There are likely to be better ways of raising money from a similar group of high-income individuals that entail less avoidance or distortion to economic activity than a 50p income tax rate (see Chapter 9 for analysis of how additional revenues could be raised from the rich).

Grants for councils to freeze council tax

The government is making £270 million available in both 2013–14 and 2014–15 for councils in England that do not increase council tax in cash terms in 2013–14 and for the devolved administrations according to the Barnett formula.

At this stage, it is uncertain how many councils will take up the option of additional funding from Westminster in return for lower council tax rates. First, the funding available from central government in 2013–14 and 2014–15 is equivalent to about 1% of council tax revenue. Local authorities that would, in the absence of this policy, have increased council tax by more than 1% in cash terms in 2013–14 would therefore not have the revenue shortfall fully plugged by the central government funding available if they instead chose to freeze council tax. Second, the central government funding is available only temporarily, for two years. Councils that do take up the option will face a choice in 2015–16 and beyond when the additional grants from central government expire. They could raise council tax to whatever it would have been in the absence of the temporary grants from central government, implying a particularly large cash rise in council tax in April 2015. Or they could continue with indefinitely lower council tax rates than they would have set in the absence of the temporary grants, and make up the permanent shortfall from elsewhere in their budgets.

The fact that a similar policy is already in place in 2012–13 – about 85% of local authorities in England froze council tax in April 2012 and received central grants that covered this for one year only[28] – may mean that local authorities are less likely to take up the government's offer again. Those that freeze council tax again would ultimately find themselves with council tax rates that have been cut in real terms for two consecutive years without any permanent funding from central government to plug the revenue

[28] Source: Communities and Local Government statistics, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/6638/2110513.pdf.

shortfall.[29] Note, however, that the government has stipulated that any local authority wishing to raise council tax by 2.0% or more in cash terms in 2013–14 would have to hold a local referendum on the matter.

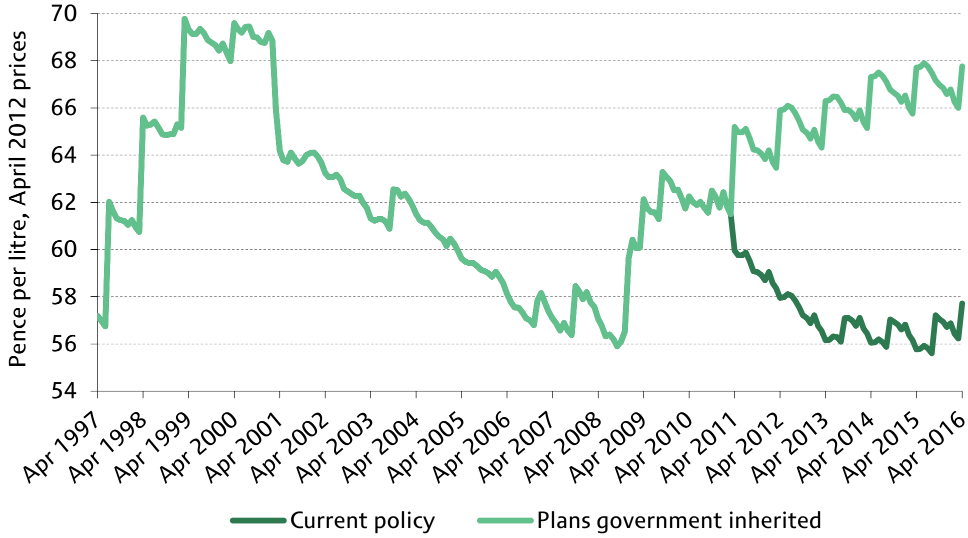
If local authorities do take up the funding and freeze council tax in cash terms in 2013–14, most people will directly gain (although the gains may be only temporary, as discussed).[30] Of course, those who do not pay council tax – students and some of those on benefits – would not be affected.

Indirect taxes: real rises for some, real cuts for others

The alcohol and tobacco duty escalators set by the previous government remain in place, meaning that total duty per unit will rise in April 2013 by RPI inflation plus 2%. This would mean a nominal increase of 5.1% under the OBR's current forecast.[31]

The rise in fuel duties in line with RPI inflation that was scheduled for April 2013 has been postponed to September 2013 (and the government has planned the same switch from April to September uprating for 2014 and 2015). When considering 2013–14 in isolation, this is a relatively minor half-year delay. But it should be seen in the context of a series of other recent real cuts to fuel duties. Current plans imply that duty on petrol and diesel until August 2013 will be one penny lower *in cash terms* than before it was cut on 23 March 2011. The last cash increase in these duties in line with inflation that was actually implemented remains that for April 2010 (and even that was implemented over three stages, with the last stage in January 2011). The resulting decline in the real value of fuel duties is illustrated in Figure 7.2. The series of cuts to fuel duties amount to

Figure 7.2. Real duty on a litre of petrol or diesel



Note: Nominal fuel duties converted to real values using the RPI.
Source: Authors' calculations.

[29] Council tax was also frozen in cash terms across England and Scotland in 2011–12, but on that occasion the UK government provided permanent funding for it.

[30] The distributional analysis in Section 7.5 assumes that local authorities in Great Britain do freeze council tax in cash terms in 2013–14 and continue with lower council tax in 2015–16 than would otherwise have been the case, despite the expiry of temporary government grants, by finding savings elsewhere in their budgets.

[31] The relevant measure of RPI inflation used for these purposes is the forecast of RPI inflation in the year to the third quarter *following* the respective change. The OBR's forecast at the time of the March 2013 Budget will determine the April 2013 increase.

approximately a £4.7 billion annual giveaway by 2015–16 relative to the plans this government inherited,[32] which included a fuel duty escalator of RPI plus one penny per litre (abolished in the March 2011 Budget). The biggest gainers from these cuts to fuel duties, as a proportion of income or expenditure, are mostly found in the middle and upper-middle of the income and expenditure distributions. In cash terms, the gains generally increase straightforwardly with income and expenditure levels, on average.[33]

Current fuel duties policy appears, at best, haphazard. The annual rise in line with inflation that was originally planned for April 2011 was delayed three times before it was finally cancelled altogether in the 2012 Autumn Statement; and the annual cash increase initially scheduled for April 2012 was also delayed once before it was eventually cancelled in the 2011 Autumn Statement. The government now plans to move the cash increases scheduled for each of the next three Aprils to the corresponding Septembers, only to return to April uprating in 2016. The credibility of this plan is highly questionable in the context of the numerous recent policy changes in this area.

The government should clarify how it thinks the real value of fuel duties should evolve in a way that provides predictability for firms, households and the public finances. Given the external costs associated with motoring, the *economic* case for continued real cuts in fuel duties is weak. There are also substantial revenue implications of continuing to cut them. If the government wants to increase fuel duties in cash terms (for instance, so that they stay constant in real terms), it could consider ways of reducing the seasonal political pressure to cancel annual upratings. One option would be to move to more frequent (for example, monthly) uprating. This would ensure a smoother time profile of real duty rates, and may cause fewer political difficulties than under the current system, in which sharper overnight jumps in fuel duties once every year seem to cause irresistible political pressure to delay or cancel them.

Beyond the immediate future, there is a strong economic case for changing the way that motoring is taxed by moving towards a system of road pricing.[34] This form of taxation could be much better targeted at the costs of road use and would be more sustainable fiscally as vehicles become more fuel-efficient over time. But this would require a clear strategy, which is lacking at present.

7.4 Welfare reforms

We now discuss the significant changes to the social security and tax credit system taking effect in 2013–14. These include measures that reduce entitlements and hence form part of the government's wider attempts to reduce the deficit. But there are also major structural changes, such as the start of the phased introduction of Universal Credit and the localisation of Council Tax Benefit (CTB).

---

[32] This is the sum of the costings given in the '2015–16' columns of table 2.1 on page 42 of the March 2011 Budget (http://cdn.hm-treasury.gov.uk/2011budget_complete.pdf); table 2.1 on page 46 of the 2011 Autumn Statement (http://cdn.hm-treasury.gov.uk/autumn_statement.pdf); and table 2.1 on page 56 of the 2012 Autumn Statement (http://cdn.hm-treasury.gov.uk/autumn_statement_2012_complete.pdf).

[33] The bottom income decile group, which gains a lot from fuel duty cuts, is an exception. This reflects the fact that this group has very high average spending (including spending on fuel) relative to its income. This suggests that many of the group have low incomes only temporarily or that their incomes have been mismeasured, providing a strong case for focusing more on effects by expenditure when considering indirect tax changes in isolation.

[34] P. Johnson, A. Leicester and G. Stoye, *Fuel for Thought: The What, Why and How of Motoring Taxation*, report for the RAC Foundation, London, 2012 (http://www.ifs.org.uk/publications/6175).

Universal Credit

Universal Credit is set to replace six means-tested benefits and tax credits for working-age claimants with a single integrated benefit. Specifically, it will replace Income Support, income-based Jobseeker's Allowance (JSA), income-based Employment and Support Allowance (ESA), Housing Benefit, Working Tax Credit and Child Tax Credit. The roll-out of Universal Credit is planned to begin in some pilot areas in the North West of England in April 2013, and in the rest of the country from October 2013. New claimants of Income Support and income-based JSA will be the first group to be treated under the new system. Existing claimants will begin to be moved onto Universal Credit from April 2014. Although relatively few families will be affected by the change during 2013–14, over time Universal Credit will represent one of the biggest changes to the structure of the welfare system for working-age people since 1948.[35]

A single benefit claim

Whereas under the current system many claimants have to submit claims for a number of different benefits to different agencies (such as local councils for Housing Benefit, the Department for Work and Pensions (DWP) for Income Support, and HMRC for tax credits), Universal Credit will require a single claim for a single benefit.[36] This should be simpler for claimants – saving them time, and possibly reducing error and increasing take-up – and be easier to administer and check (reducing error and fraud). By integrating the systems of out-of-work benefits and in-work tax credits, it might also encourage more people to enter paid work by smoothing the transition.

Less frequent payments

Most families will receive Universal Credit on a monthly basis, with entitlements based on circumstances during the previous month and calculated using 'real-time' information from employers. This should result in far fewer under- and over-payments than the current system and may reduce the amount of fraud and error. The flip side is that using information from the previous month (rather than self-reported information) may mean payments do not respond to changes in circumstances as quickly as they can now.[37] Concerns have also been raised about the ability of Universal Credit recipients to budget properly on a monthly, as opposed to weekly, basis and to manage payment of rent to landlords[38] (Housing Benefit is generally paid directly to landlords in the social rented

---

[35] IFS researchers have previously analysed Universal Credit in some detail, using information available from the government's White Paper *Universal Credit: Welfare that Works* (DWP, 2010, Cm 7957, http://www.dwp.gov.uk/docs/universal-credit-full-document.pdf). See M. Brewer, J. Browne and W. Jin, 'Universal Credit: a preliminary analysis of its impact on incomes and work incentives', *Fiscal Studies*, 2012, 33, 39–71 (available at http://www.ifs.org.uk/publications/6147). However, changes to Universal Credit earnings disregards and conditionality were subsequently announced at the 2012 Autumn Statement. IFS researchers plan to publish updated detailed analysis of Universal Credit later in 2013.

[36] Although claimants will need to make a separate claim to their local authority for Council Tax Benefit (see below).

[37] Under the current system, means-tested benefits are assessed on a weekly basis. Tax credits are assessed annually, but prospectively, so if a claimant anticipates a change in income over the coming year they can allow for this when making their tax credit claim, and can report a change in income or other circumstances at any time and have their tax credit payments adjusted accordingly (but if they fail to report relevant changes in income or circumstances, they may have to deal with under- or over-payments).

[38] See, for instance, A. Tarr and D. Finn, *Implementing Universal Credit: Will the reforms improve the service for users?*, Joseph Rowntree Foundation, 2012 (http://www.jrf.org.uk/publications/implementing-universal-credit).

sector, which currently accounts for about two-thirds of Housing Benefit claimants[39]). The government has stated that these changes are designed to encourage responsibility and to ensure that Universal Credit payments 'mimic work and receipt of a salary'.[40]

Extension of work search requirements

The Universal Credit regulations allow for the extension of work search requirements to many more individuals than currently face them under the JSA regime. Under the existing system, income-based JSA entitlements and therefore work search requirements will generally cease at £77 of earnings per week for a single person and £123 for a couple, in 2013–14. The current plan is that, initially, work search requirements under Universal Credit will continue to be applied to the same group as currently subject to them under the JSA regime.[41] However, regulations allow for those receiving Universal Credit to eventually be expected to look for higher-paid employment (whether through more hours of work or a higher wage) if they earn less than 35 times the minimum hourly wage per week (currently approximately £217),[42] whilst couples may be required to earn double that between them (approximately £433). Over time, therefore, the number of people subject to conditionality could increase substantially, especially among couples.

Changes in benefit withdrawal rules and entitlements

Out-of-work entitlements to benefits will be the same as under the current system for most claimants, but there will be substantial increases to 'earnings disregards' – that is, the amounts that one can earn before entitlement starts being reduced. The biggest increases in disregards are for those with children (especially lone parents) and those with a 'limited capability for work'. Those not claiming support for housing costs (mostly homeowners) will also generally have higher earnings disregards than otherwise-identical households that are claiming support for housing costs.

As earnings rise above the applicable earnings disregard, there will also be a reduction in the rate at which entitlements are tapered away. Existing out-of-work benefits are withdrawn pound for pound as after-tax earnings rise, whereas Universal Credit recipients will lose only 65p of entitlement for every £1 increase in after-tax earnings. Together with the higher earnings disregards, this will increase the incentive for many households to have someone in paid work, because they will get to keep more of their benefits when doing so. Hence, the most striking effect of Universal Credit on financial work incentives is to strengthen them significantly for those households facing the weakest incentives under the current system.[43]

---

[39] Source: the caseload figures in the 'Housing Benefit' sheet Benefit Expenditure Tables (available at http://statistics.dwp.gov.uk/asd/asd4/index.php?page=medium_term). For 2012–13, the row labelled 'Total Social Sector' is 67% of the row labelled 'Total'.

[40] As stated in the latest DWP Impact Assessment (http://www.dwp.gov.uk/docs/universal-credit-wr2011-ia.pdf).

[41] See the Explanatory Memorandum to the Universal Credit Regulations, http://www.legislation.gov.uk/ukdsi/2013/9780111531938/pdfs/ukdsiem_9780111531938_en.pdf.

[42] Based on the adult rate of the National Minimum Wage applicable between October 2012 and September 2013.

[43] Note, however, that the impact of Universal Credit on work incentives is not always positive. A significant number of households that currently benefit from Working Tax Credit will face a somewhat weaker incentive to have someone in work because entitlements to Universal Credit can be lower than entitlements under the current system of benefits and tax credits. Furthermore, households will tend to face a weaker incentive to have a second worker in work. This is partly due to a higher withdrawal rate for Universal Credit than is the case currently for tax credits alone. However, it also reflects the fact that those households that are entitled to more support under Universal Credit when one person works than currently will have *more support to lose* if a second worker enters work.

In particular, the new out-of-work claimants placed on Universal Credit in 2013–14 would keep more of their welfare entitlement if they entered a low-paid job than they would under the current system, and this will act to substantially strengthen financial work incentives for some. This might also create an incentive for unemployed people who expect to be able to find a job with low earnings to delay their benefits claim until the Universal Credit roll-out begins in October 2013.

On the other hand, Universal Credit entitlement will be reduced by £1 for every £1 of *unearned* income, such as income from savings or property or spousal maintenance (but not child maintenance), and those with over £16,000 of financial capital will not be entitled to Universal Credit at all. This is less generous than the treatment under tax credits and the existing means-tested benefits. This means new out-of-work claimants after October 2013 with unearned income or financial assets will be worse off when claiming Universal Credit than they would have been under the existing system. In addition, new claimants where one partner is aged over and the other under the female State Pension Age (61 years and 9 months in October 2013) will see a very significant reduction in their entitlement – this group will no longer be able to claim Pension Credit.[44] The changes may incentivise these groups to bring forward benefit claims to before the national roll-out of Universal Credit in October 2013; or they may discourage them from moving into employment in the short term if they think there is a risk of them losing that job and subsequently having to make a new out-of-work benefit claim, at which point they would be treated under the Universal Credit rules. Probably at least in part because of lower entitlements for some new out-of-work recipients than under the current system, the roll-out of Universal Credit is expected to reduce entitlements by £70 million in 2013–14, even though it is a net giveaway to households in the long run.

DWP's Impact Assessment[45] estimates that, overall, changes in financial work incentives as a result of Universal Credit could lead to between 100,000 and 300,000 additional people in employment in Great Britain. DWP also estimates that Universal Credit will increase average net incomes within the lowest-income 40% of the population, and somewhat reduce average net incomes within the next 30% of the population (with little effect on the top 30%). Around 3.1 million households will have entitlements increased and 2.8 million households will have them reduced in the long run, relative to the current system (though note that, in the shorter term, cash-terms transitional protection applies at the point of transition to the Universal Credit system). Among out-of-work households, 0.6 million will gain in entitlement, 1.1 million will lose in entitlement and 2.4 million will have entitlements unchanged in the long run.

In summary, the start of the roll-out of Universal Credit in 2013–14 is the beginning of a process that will have substantial impacts on the incomes and work incentives of many people. It also has the potential to simplify the structure and operation of the means-tested benefits system. Relatively few people will feel the impact during 2013–14, but some of those who do may be substantially affected.

[44] This creates a particularly large 'couple penalty' for such couples, whereby benefit entitlements are lower when claiming as a couple than when claiming as two single adults.

[45] http://www.dwp.gov.uk/docs/universal-credit-wr2011-ia.pdf.

Below-inflation increases in benefit and tax credit rates

Many benefit and tax credit rates will rise by less than the now-default CPI inflation in 2013–14, cutting the welfare bill by about £1.1 billion in that year.[46] This is due to a combination of the start of a three-year policy of uprating many working-age benefits and tax credits by 1% in cash terms, announced in Autumn Statement 2012; previously-announced cash-terms freezes for Child Benefit and for the basic element and 30-hour premium in Working Tax Credit; and a cash-terms reduction in the maximum award of the Savings Credit element of Pension Credit.

The reduction in the Savings Credit is the only discretionary reduction to a pensioner benefit and is being used to pay for an above-indexation increase to the guarantee element of Pension Credit (some pensioners with modest levels of private income will lose overall from these two changes, and pensioners with low incomes claiming Pension Credit will gain).

Major benefits and tax credits that will continue to rise by at least CPI inflation are: most pensioner benefits (notwithstanding the two changes to Pension Credit mentioned above);[47] Disability Living Allowance; the support component within Employment and Support Allowance (this goes to the ESA recipients assessed as belonging to the more disabled category who are not expected to engage in work-related activities); Incapacity Benefit; and disability, carers' and pensioners' premiums in benefits and tax credits.

Nominal increases of 1% in April 2013 imply a 1.2% cut relative to the default of CPI indexation. The nominal freezes for Child Benefit and elements of Working Tax Credit imply a 2.2% real cut on the same basis. Given the OBR's current CPI inflation forecasts, the three-year 1%-uprating policy implies cumulative 3.9% cuts relative to CPI uprating for the affected benefits and tax credits by 2015–16. But note that, as uprating has been set in advance in cash terms, the actual implications for real benefit levels by 2015–16 depend upon unknown future inflation rates.[48]

Clearly, these below-inflation increases and cash freezes should be seen in the context of a government wanting to reduce spending on benefits and tax credits as part of its fiscal consolidation efforts. They represent a simple and sizeable reduction in expenditure that is broad-based (among working-age welfare recipients) rather than focused on particular groups of claimants. Because the cut is so broad-based, the patterns of losses essentially reflect the patterns of benefit and tax credit entitlement among the working-age population. The below-CPI inflation increases and cash freezes in 2013–14 will reduce real entitlements for about 2.4 million out of 2.8 million out-of-work households of working age (who will lose about £90 in 2013–14, on average) and 7.3 million out of 14.1 million in-work households of working age (who will lose about £80 in 2013–14, on average).[49] Note that about 2.7 million of those 7.3 million in-work households affected

[46] This is the sum of the relevant figures in Table 7.1.

[47] The 'triple lock' means that the Basic State Pension is set to rise by 2.5% in April 2013, more than CPI inflation of 2.2%. It will rise by the maximum of CPI inflation, earnings and 2.5% in subsequent years.

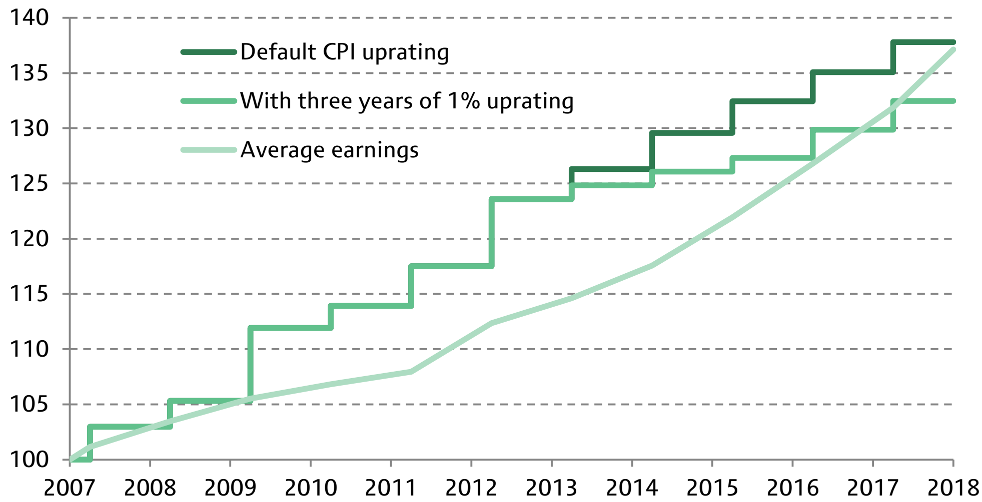
[48] Note, however, that the policy cannot result in real *rises* in benefits, as the Welfare Benefits Uprating Bill (http://www.publications.parliament.uk/pa/bills/cbill/2012-2013/0116/20130116.pdf) stipulates that the 1% uprating does not apply in April 2014 and April 2015 if the relevant measures of inflation turn out to be less than 1%.

[49] Note that 'working-age' here is defined as households in which no adult is above the female State Pension Age, because these households are ineligible for Pension Credit, and are therefore the households primarily affected by the cuts to working-age welfare.

will lose only from the freeze to Child Benefit (at an average loss of about £65 in 2013–14).[50] Of course, the measures have the biggest impact on low-income households.

The government has pointed out that benefits uprated in line with prices have risen more quickly than average earnings since the financial crisis, as is shown in Figure 7.3.[51] This is because earnings have not kept pace with inflation, whereas price-indexed benefits have broadly done so (by definition). This pattern is unusual – in normal economic times, real earnings grow, and price-indexed benefits therefore fall relative to earnings (although above-indexation increases have seen some entitlements grow substantially faster than prices over the last 15 years, particularly for families with children). Relative to that 'normal' scenario, the recent faster growth in out-of-work benefits than in earnings looks even more dramatic. On the other hand, as indicated by Figure 7.3, since earnings are expected to start outpacing prices once more, they would soon have recovered their pre-crisis position relative to out-of-work benefits anyway. The three-year 1%-uprating policy implies that this will happen two years earlier than it would otherwise have done (by 2016–17 as opposed to 2018–19).

Figure 7.3. Average earnings and out-of-work benefits (Jan 2007 = 100)



Source: Past earnings from ONS series DTWM, ROYK, MGRZ and MGRQ. Past benefits from DWP (JSA personal allowance for a single person over 25). Forecasts of inflation and earnings growth from OBR.

The government's current default assumption about benefit uprating is straightforward price indexation. If the government doubts whether this is the appropriate rule – which seems plausible, given its recent references to relative patterns of benefits and earnings growth[52] – then it would be helpful for it to clarify its position on long-run indexation policy: this matters enormously for the future shape of the benefits system and for the

[50] Source: authors' calculations using the 2010–11 Family Resources Survey and TAXBEN, the IFS tax and benefit microsimulation model.

[51] The outpacing of earnings by benefit rates is one reason why 2010–11, the latest year for which data are available, saw a significant drop in inequality, with incomes falling less quickly towards the bottom of the distribution than at the middle and top end of the distribution. For more details, see J. Cribb, R. Joyce and D. Phillips, *Living Standards, Poverty and Inequality in the UK: 2012*, IFS Commentary 124, 2012 (http://www.ifs.org.uk/publications/6196)

[52] For example, in the Chancellor's 2012 Autumn Statement speech (http://www.hm-treasury.gov.uk/as2012_statement.htm), he said 'we have to acknowledge that over the last five years those on out of work benefits have seen their incomes rise twice as fast as those in work. With pay restraint in businesses and government, average earnings have risen by around 10% since 2007. Out of work benefits have gone up by around 20%.'

public finances. In doing so, a couple of important points are worth bearing in mind. First, a policy of straightforward earnings indexation would imply substantially *higher* expected benefit rates in the long run than currently planned, and would therefore increase projected welfare spending.[53] Second, a policy of uprating by the lesser of inflation and earnings growth each year is unlikely to be desirable. This would imply that, in the long run, benefits would rise by less than both prices and earnings. Whilst one can always reasonably debate the appropriate *level* of entitlements, it is not clear why any government should want benefits to be falling indefinitely over time both in real terms and relative to earnings.

Disability Living Allowance replaced by Personal Independence Payment

From April 2013, the Personal Independence Payment (PIP) will start to replace Disability Living Allowance for adults aged under 65. This is a major reform: DLA is the most widespread benefit payment on grounds of disability, with 1.9 million working-age claimants and an estimated total spend for that group of £7.5 billion in 2012–13. This compares with only 1.2 million working-age claimants and an exchequer cost for that group of £4.3 billion in 1997–98 (in 2012–13 prices). The transition from DLA to PIP is expected to reduce spending by about £1.5 billion per year by 2016–17, as a result of an expected one-fifth of DLA claimants being assessed as ineligible for PIP.[54] Existing DLA claimants aged 65 or over will be able to continue on DLA (new claimants aged 65 or over already have to claim Attendance Allowance rather than DLA, and that will continue). The government has committed to a separate consultation before any move to extend the migration from DLA to PIP for children currently entitled to DLA (of whom there are about 350,000).[55]

The transition to the PIP is scheduled to take place between 2013 and 2016. New claimants aged under 65 will be assessed for entitlement to PIP from April 2013 in a small number of areas[56] and from June 2013 elsewhere. Reassessment of existing DLA claimants aged under 65 will begin in October 2013 and is expected to be completed by the end of 2016.

The government has said that the disability test for PIP will involve an assessment of the ability of an individual to participate fully in society rather than the severity of impairment.[57] This means that, unlike in DLA, there will be no medical conditions that will lead to automatic entitlement to PIP. The PIP will also involve continuing assessment of claimants' needs. The assumption is that it will be awarded for a fixed term, of between one and ten years. Claimants will automatically be reassessed at the end of their term, as well as during that term if circumstances change.

[53] It is worth noting that the long-term public finance forecasts produced by the OBR assume that benefit rates will rise in line with earnings rather than prices. This is because, over many years, default price indexation would likely lead to a significant decline in the value of benefits relative to earnings.

[54] Page 36 of HM Treasury, *Budget 2010 Policy Costings*, June 2010 (http://www.hm-treasury.gov.uk/junebudget_costings.htm).

[55] Figures on current and historical expenditure and claimant numbers in this paragraph are from DWP's Benefit Expenditure Tables (http://research.dwp.gov.uk/asd/asd4/index.php?page=medium_term).

[56] Merseyside, North West England, Cumbria, Cheshire and North East England.

[57] Details of the policy described here can be found at http://www.dwp.gov.uk/pip.

Existing DLA claimants are found largely towards the middle of the income distribution – often because their DLA income pushes them up to the middle of the income distribution (though note that they are likely to face higher living costs due to their disability, and standard measures of household income do not account for this). However, it is unknown whether those assessed to be eligible for PIP will be similarly distributed.

Localisation and funding cut for council tax support

From April 2013, Council Tax Benefit (CTB) will be abolished across Britain and support for low-income families in paying their council tax will be localised. English local authorities, and the devolved Scottish and Welsh governments, will be able to design their own schemes. At the same time, funding will be cut by 10% in the sense that the new central government grants will be based on 90% of what the UK government estimates would otherwise have been spent on CTB in that nation or English local authority. Northern Ireland is in practice affected in much the same way as Scotland and Wales, although formally the details are slightly different.[58] Entitlements for pensioners in England will be set by the UK government and will be maintained at their existing level. This implies an estimated 19% reduction in funding for the English working-age population.[59]

There is no obligation for local authorities in England, or the devolved governments, to spend the amount of the new grant on council tax support: they may, for example, choose to maintain support at its existing level and find the necessary savings elsewhere in their budgets, or to cut entitlements by more and use the surplus for other purposes.

IFS researchers have previously analysed the options for designing a replacement for CTB for local authorities in England and the Welsh government.[60] There is, as ever, a trade-off between protecting those with the lowest incomes and maintaining incentives to work. Reducing entitlements for all claimants slightly strengthens work incentives but imposes significant losses on even the poorest households. Reforms that means-test support for council tax more aggressively lead to weaker work incentives than those that reduce support for all claimants. In order to save the full 10%, councils would have to either reduce support for those currently entitled to maximum CTB – those on the lowest incomes – or significantly weaken work incentives via much more aggressive means-testing.

The devolved governments have all decided that the existing systems of support for local property tax (council tax in Scotland and Wales, and domestic rates in Northern Ireland) will be retained in 2013–14. Hence, by implication, they will need to find savings elsewhere in their budgets equivalent to about 10% of the cost of providing that support. Contrastingly, research by the New Policy Institute[61] has found that, of 235 local authorities in England surveyed at the time of writing (out of a total of 326), only 20% will maintain the existing system of support and hence absorb the full funding cut

---

[58] Northern Ireland's system of local property tax is domestic rates (not council tax) and support for that tax is provided through 'rates rebates'. In practice, the rates rebates scheme mirrors CTB in Great Britain. The UK government will now give Northern Ireland a grant equal to 90% of the funding that it expects it would otherwise have given for the cost of rates rebates.

[59] S. Adam and J. Browne, *Reforming Council Tax Benefit*, IFS Commentary 123, 2012 (http://www.ifs.org.uk/publications/6183).

[60] Ibid.

[61] *Council Tax Support Update*, 31 January 2013, http://counciltaxsupport.org/the-story-so-far/.

elsewhere in their budgets (or levy higher council tax rates than they would otherwise have done). About two-thirds of English local authorities have decided that all working-age households will pay at least some council tax. Around 50% of such local authorities have set a minimum payment of 8.5% of the council tax bill and around 35% have opted for a minimum payment of between 10% and 20% of the bill, with the remainder setting a minimum payment of more than 20% of the bill.[62] Another common feature of the schemes is to reduce or remove the Second Adult Rebate, which claimants are entitled to if they share their home with someone on a low income. Other less common changes include introducing a cap on support entitlements to the amount available for a band D property, reducing the amount of financial assets claimants can have, changing backdating rules, and counting other benefits as income when assessing support entitlement. Very few (6%) will change the withdrawal rate to means-test support more aggressively.

The stated aims of localisation are to allow support to reflect local priorities, and to strengthen the incentives of the devolved governments and English local authorities to promote employment and growth in the local economy. But it could also change other incentives. It could reduce incentives to increase council tax rates, reduce incentives to facilitate low-value housing development, increase incentives to discourage low-income families from living in the area, reduce incentives to encourage take-up of support and strengthen incentives to reduce overpayments. The overall pattern of change in incentives is complex, empirically unknown and not unambiguously positive.

It is difficult to think of reasons why the government's original plan to integrate CTB into Universal Credit was inferior to the current policy (with, if the government had wished, a centralised cut to reduce spending by £0.5 billion). Keeping them separate creates difficult issues regarding how they will interact (a particularly important question is whether Universal Credit will count as income in any CTB means test) and reintroduces the possibility of people being subject to overlapping means tests and hence having extremely weak work incentives. By localising support for council tax, the central government has passed these difficult issues on to the devolved governments and local authorities, which have no experience in designing welfare systems; and the resulting variation in council tax rebate schemes that is clearly developing will reduce transparency and increase complexity and bureaucracy. Sadly, this is all at odds with the basic (commendable) principle of simplification underlying Universal Credit.

Uprating of Local Housing Allowance rates capped by CPI inflation

Local Housing Allowance (LHA) is Housing Benefit for those in privately rented accommodation.[63] There are currently about 1.3 million LHA recipients in Great Britain, claiming an average of about £107 per week.[64] They can, subject to a means test, have their rent[65] covered up to a maximum of their applicable 'LHA rate'. These LHA rates vary

[62] The large number of councils choosing an 8.5% minimum payment likely reflects the £100 million made available by the UK government for one year to councils that limit the minimum payment to 8.5% of council tax liabilities and whose council tax support schemes satisfy certain other conditions. IFS researchers have previously discussed this temporary funding in an observation (http://www.ifs.org.uk/publications/6410).

[63] Excluding those whose Housing Benefit claim began before April 2008, as they are still treated under pre-LHA rules.

[64] As of August 2012 (see http://research.dwp.gov.uk/asd/index.php?page=hbctb).

[65] Minus deductions for non-dependants in the household.

geographically, according to Broad Rental Market Areas (BRMAs), and by family type, which for these purposes determines the number of bedrooms that the family is deemed to need. There are 192 BRMAs in Great Britain, which makes them about twice the average size of local authorities.

Since April 2011, LHA rates have been set at the 30th percentile of non-LHA private sector rents within the relevant BRMA and 'number of bedrooms' category (subject to overall national caps, which are binding in parts of London); previously, rates were set at the 50th percentile. Hence, since the introduction of LHA in April 2008, the maximum amounts of rent against which private sector tenants can claim Housing Benefit have depended upon the current applicable rent distribution in the local area. There is therefore substantial geographical variation. For example, LHA rates in Great Britain currently range from £64.62 per week in North Powys and Blaenau Gwent to £250 per week in Central London for families without children; and from £85 per week in Merthyr Cynon to £340 per week in Central London for families with three children.[66]

From April 2013, the link with current rents will in general be broken and LHA rates will rise in line with CPI inflation. The exception is that they will be set at the 30th percentile of local rents if that is lower than the implied CPI-uprated LHA rate. Assuming that rents continue to grow in real terms, this condition will become increasingly irrelevant over time for determining year-to-year changes in LHA rates. The government expects the change to cut LHA spending by about £90 million in 2013–14, but the savings will tend to grow indefinitely as long as private sector rents continue to grow in real terms.

In the 2012 Autumn Statement, the government announced that, in April 2014 and April 2015 only, LHA rates would in fact rise by no more than 1% in cash terms, except in those areas where rent growth is highest where they will instead rise in line with CPI inflation as previously planned (30% of what the exchequer would otherwise have saved from the temporary switch from CPI uprating to 1% uprating will be used to fund these exemptions). Here we ignore this and focus on the new long-run policy of capping annual LHA rate increases at CPI inflation, which is also the policy that will apply in April 2013.

The immediate consequence of the change is that LHA rates relative to local rents will tend to decline, and to decline more in areas that experience faster rent growth after 2012–13. Where local rents grow in real terms, those LHA claimants whose rent levels are already at least as high as their LHA rates will be affected by the reforms immediately; other claimants will be affected in time, as their rents will overtake their LHA rates and hence they will no longer have rents fully covered by LHA. Table 7.2 shows the characteristics of private sector tenants on Housing Benefit.[67] About nine in ten of them are of working age, and about one in three of those working-age claimants are single and out of work. Eventually, all of this group could be affected by the change to indexation of LHA rates. But note that the group that is affected immediately – those with rents already

[66] Assumes children are all aged under 16. LHA rates for the period April 2012 to March 2013 (i.e. current rates) in each BRMA in England are downloadable from the Valuation Office Agency at http://www.voa.gov.uk/corporate/RentOfficers/LHARates/april2013lha.html; and the figures for Scotland and Wales are available at http://www.scotland.gov.uk/Topics/Built-Environment/Housing/privaterent/tenants/money/localhousingallowance/Figures-1/2013 and http://wales.gov.uk/topics/housingandcommunity/housing/private/renting/rentofficers/publications/lha13/?lang=en respectively.

[67] About 18% of this group (as of August 2012 – see http://research.dwp.gov.uk/asd/index.php?page=hbctb) are still assessed under pre-LHA rules because their claim began before April 2008, so they could not be affected by this reform immediately. But, in time, all private sector tenants will be assessed under the LHA rules; the table is intended to describe the types of people who will be affected by this change in the long run.

at least as high as their LHA rate – may have different characteristics from other LHA recipients. For example, since they are already financing their rent partly via non-LHA resources, they may be relatively likely to be in work. Nevertheless, the table gives a sense of the types of people who will be affected by this policy change in the long run.

As with the other substantial LHA cuts that have already been implemented since April 2011,[68] though, a key uncertainty is the economic incidence of the reforms between tenants and landlords. Landlords who let to LHA claimants and who would otherwise be willing to let the property for less than the LHA rate have a financial incentive to raise rents to whatever the LHA rate is, since they know that LHA claimants will not face the cost. So cuts to rent subsidies may result in cuts to rents. The extent to which this happens will depend on the relative sensitivities to rent levels of supply of, and demand for, private rental accommodation; and on whether landlords of LHA tenants are willing and able to let their properties to non-LHA claimants who are unaffected by these reforms.

Table 7.2. Characteristics of private sector tenants on Housing Benefit

Region/nation	
North East	5%
North West	14%
Yorkshire and the Humber	7%
East Midlands	6%
West Midlands	9%
East of England	8%
London	14%
South East	12%
South West	10%
Wales	7%
Scotland	5%
Northern Ireland	4%
Household type and work status	
Single without children, out-of-work	15%
Single with children, in-work	3%
Single parent, out-of-work	14%
Single parent, in-work	7%
Couple without children, out-of-work	5%
Couple without children, in-work	4%
Couple with children, out-of-work	9%
Couple with children, in-work	16%
Single pensioner	7%
Couple pensioner	4%
Multi-family household without children	8%
Multi-family household with children	9%

Note: Regions are the former Government Office Regions.
Source: Authors' calculations using 2010–11 Family Resources Survey.

[68] These are: setting LHA rates at the 30th percentile of the applicable rent distribution rather than the 50th percentile; capping rates in all BRMAs at the four-bedroom rate (rather than the five-bedroom rate); introducing overall national caps – binding in parts of London – on LHA rates for each room band; and abolition of the £15 per week in LHA over and above rent that could be claimed where rent was lower than the applicable LHA rate.

Evidence from reforms to Housing Benefit in the UK in the mid-1990s, and from studies of rent subsidies in other countries, suggests that a substantial proportion of rent subsidies may indeed be incident on landlords.[69] So, while the effects of the current reforms need to be tested empirically, there is some reason to think they may result in lower rents than otherwise.

The details of this policy will lead to some very odd effects. Although the policy will break the link between levels of rent subsidy and levels of local rents, it will retain a link with *historical* levels of local rents. There seems no justification for geographical relativities in rent subsidies in 2050 depending upon geographical differences in rent levels in 2012.

One could make the argument that LHA rates should be more uniform across the country, so that claimants face some of the additional cost of choosing to live in higher-rent areas at greater expense to the taxpayer. But to the extent that there *is* any link between LHA rates and rents, the link should be with current rents (not historical ones). The policy does not achieve any move towards greater geographical uniformity compared with the current system: it will retain geographical variation in LHA rates just as now, based on historical differences in rent levels. If rents in high-rent areas did happen to grow more rapidly than those in low-rent areas, uprating all LHA rates by the same proportion rather than in line with local rents would stop further divergence in LHA rates that would otherwise have taken place. But the policy could also prevent convergence of LHA rates: if an expensive area experiences relatively low rent growth (but remains expensive), the effect of the change will actually be to strengthen the incentives of tenants to live in that area over cheaper areas with faster rent growth. Indeed, if the ranking of BRMAs by their rent levels changes at all after 2012–13 – as it surely will – then in future there will be areas that have *higher* rent levels than other areas and yet have *lower* LHA rates.

The decision to set LHA rates each year at the *minimum* of the 30th percentile of local rents and last year's LHA rate uprated in line with CPI inflation could also have strange impacts. This is because mere *volatility* in local rents in the short run could affect the *level* of LHA rates in an area permanently. And rents at a local level can indeed be volatile from year to year. For example, the LHA rate for people without children is currently £75 per week in both North Nottingham and West Pennine.[70] Rents at the 30th percentile have recently declined in North Nottingham, so its LHA rate from April 2013 will be reduced to £69.23. In West Pennine, rents at the 30th percentile have recently risen and the LHA rate will rise with CPI inflation in April, to £76.65 – 11% higher than North Nottingham's. Imagine that, subsequently, rents in both areas always grow in real terms, but they initially grow faster in North Nottingham until rent levels in both areas are the same once more. LHA rates in both areas would rise in line with CPI inflation after 2013–14. The LHA rate in North Nottingham in (for example) 2050 would therefore be 11% lower than that in West Pennine, purely because of rent volatility more than 30 years previously. This highlights one reason why using 'minimum rules' for uprating is generally not sensible: such rules mean that *future levels* of a benefit can depend on *past volatility* in what it is indexed to (for example, prices, earnings or rents).

[69] S. Gibbons and A. Manning, 'The incidence of UK Housing Benefit: evidence from the 1990s reforms', *Journal of Public Economics*, 2006, 90, 799–822; G. Fack, 'Are housing benefits an efficient way to redistribute income? Evidence from a natural experiment in France', *Labour Economics*, 2006, 13, 747–71; S. Susin, 'Rent vouchers and the price of low-income housing', *Journal of Public Economics*, 2002, 83, 109–52.

[70] For current LHA rates and those applicable from April 2013, see http://www.voa.gov.uk/corporate/RentOfficers/LHARates/april2013lha.html.

Given the desire to find welfare savings as one element of the deficit reduction package, it is understandable that cuts to Housing Benefit – which is one of the largest working-age benefits in expenditure terms – are considered. But the details of this particular policy do not look well designed. It may lead to differences in future LHA rates in different parts of the country resulting purely from historical *volatility* in local rents. And it will mean that future geographical differences in LHA rates will depend on past differences in rents but not on current differences, so that (for example) an area where rent is higher than in another area could end up with the lower LHA rate.

Cuts to Housing Benefit for 'underoccupying' working-age social sector tenants

From April 2013, working-age[71] Housing Benefit (HB) claimants in social housing who are deemed to be underoccupying their homes will have their maximum HB awards reduced. Bedroom needs will be assessed as a function of family type, in exactly the same way as already happens for LHA claimants in the private rented sector.[72] The stated rationales for the policy are to reduce expenditure, to encourage more efficient use of the social housing stock and to treat private renters (whose HB entitlements are already linked to family size) and social renters more equitably. It is expected to affect about 660,000 families in 2013–14, which is about one-third of working-age social-renting Housing Benefit claimants. The 81% of affected families who have one more bedroom than they are deemed to need will have awards cut by 14%; the other 19% of those affected, who have at least two more bedrooms than they are deemed to need, will have awards cut by 25%. The affected families stand to lose an average of about £14 per week, and this is expected to cut the Housing Benefit budget by about £490 million per year.[73]

Who 'underoccupies' social housing? Table 7.3, based on DWP's Impact Assessment,[74] shows how the proportion of working-age social sector Housing Benefit claimants who are underoccupying varies geographically and by claimant type.

Social landlords may respond to the policy by allocating families to properties using different criteria;[75] increasing efforts to identify overcrowding and underoccupying tenants and encourage them to exchange homes; and building more smaller (particularly one-bedroom) properties. Affected tenants will have somewhat strengthened work incentives (there will be less Housing Benefit to lose if they enter work or increase their earnings) and there may therefore be employment responses on their part. If they are unable to find an appropriately sized socially rented property, they may respond by moving to a private rental property and claim LHA (this could, in principle, end up as more or less expensive to the taxpayer than the original Housing Benefit claim). Another possible behavioural response, which illustrates the sorts of trade-offs one always has to

[71] 'Working-age' for these purposes is defined as between the ages of 16 and the female State Pension Age. This is gradually rising from its current level of 61 to 66 by 2020. Therefore, all else equal, the number of claimants affected by this measure will rise slightly over time.

[72] In addition to one room for a childless single person or couple, families are considered to need additional rooms for any other person in the household aged 16 or over, any two children of the same sex aged under 16, any two children (regardless of sex) aged under 10, and any other child.

[73] The last figure comes from table 2.2 of HM Treasury, *Budget 2012*, March (http://www.hm-treasury.gov.uk/budget2012.htm). Other figures in this paragraph are from DWP's Impact Assessment, June 2012 (http://www.dwp.gov.uk/docs/social-sector-housing-under-occupation-wr2011-ia.pdf).

[74] http://www.dwp.gov.uk/docs/social-sector-housing-under-occupation-wr2011-ia.pdf.

[75] For example, if young people without children are currently given properties with more than one bedroom in expectation that they will shortly have children, this may be less likely in future.

Table 7.3. 'Underoccupying' Housing Benefit claimants by region/nation and claimant type

	Underoccupying claimants		
	Number	**% of working-age claimants**	**Average loss per week**
Great Britain	660,000	31%	£14
Region			
Wales	40,000	46%	£12
North West	110,000	43%	£14
Yorkshire and Humberside	80,000	43%	£13
North East	50,000	37%	£13
Scotland	80,000	33%	£12
West Midlands	60,000	31%	£13
Eastern	50,000	30%	£15
East Midlands	40,000	27%	£12
London	80,000	22%	£21
South East	40,000	22%	£15
South West	30,000	20%	£15
Claimant type			
Age 60 or over but under Pension Credit age	50,000	53%	£15
Under 60, couples with children	70,000	20%	£15
Under 60, lone parents	150,000	21%	£13
Under 60, couples without children	80,000	68%	£16
Under 60, single people	320,000	38%	£14

Source: DWP's Impact Assessment, June 2012 (http://www.dwp.gov.uk/docs/social-sector-housing-under-occupation-wr2011-ia.pdf).

bear in mind in designing benefit policies, is in fertility rates. One way for an underoccupying family to avoid an increased rent shortfall without having to move home is to have an additional child or, perhaps more plausibly, bring forward the birth of an additional child that they would have had anyway. About 42% of Housing Benefit claimants affected by the reform are aged under 45 (roughly childbearing age).[76]

It is worth noting that the greater the extent to which the policy encourages more efficient usage of social housing, the less it will reduce expenditure on Housing Benefit. If underoccupying and overcrowding households effectively swap homes in response, then both groups of households will be able to cover all their rent through HB claims, just as they could before the policy was implemented.

Benefits cap

In April 2013, an overall benefits cap will be introduced for working-age families.[77] It will be set at £350 per week for childless single people and £500 per week for other families.

---

[76] See A. Clarke and P. Williams, *Under-Occupation and the New Policy Framework*, Cambridge Centre for Housing and Planning Research, 2011 (http://www.cchpr.landecon.cam.ac.uk/Downloads/Underoccupation%20report.pdf).

[77] The government has recently announced that the cap will apply immediately in only four local authorities – Bromley, Croydon, Enfield and Haringey. The cap will be fully in place throughout Great Britain by 'summer 2013'. See http://www.dwp.gov.uk/newsroom/press-releases/2012/dec-2012/dwp139-12.shtml. The

The government expects this to affect a relatively small number of households (56,000 in Great Britain). But those who are affected will tend to lose substantial amounts, with average reductions in entitlement of £93 per week. This will reduce the benefits bill by about £275 million in 2013–14.[78]

The cap will initially be implemented through the Housing Benefit system (by local authorities), and then through Universal Credit. There are exemptions (apart from the fact that it applies only to those of working age) for war widows and widowers, families in receipt of DLA, the PIP, the support component of ESA, an industrial injuries benefit or Working Tax Credit, and those on Universal Credit whose family earnings exceed £430 per month. It will also not apply for 39 weeks after the end of an employment spell if that spell lasted for at least one year.

The biggest benefit (in terms of expenditure) that will not be counted for the purposes of determining whether a family's entitlement exceeds the cap is Council Tax Benefit, which is being localised and kept separate from Universal Credit (see above). The childcare element of Universal Credit will also be excluded (childcare support is effectively excluded for those not on Universal Credit, because it is currently paid through Working Tax Credit, whose recipients are exempt from the cap). Non-cash benefits and passported benefits (for example, free school meals and free prescriptions) will also not count.

The level of the benefits cap means that it will essentially only affect families with large numbers of children and/or high housing costs who are consequently receiving a lot of child-contingent support and/or Housing Benefit.[79] This is reflected by the fact that an estimated 73% of affected households contain at least three children and 49% are in Greater London (where rents are high).[80]

The government has said that it hopes there will be two forms of behavioural response: families may move to cheaper accommodation to reduce their housing costs and/or may take up paid work because their out-of-work benefit entitlement will have been reduced. A third possible form of behavioural response is in fertility rates, since the cap will effectively reduce state financial support for some large families.[81] If this were the main intended impact, though, one would expect to see the policy affecting only claims for additional children. A fourth possible behavioural impact is for fewer people to cohabit (or, at least, declare that they cohabit), since the benefits cap is to apply at the family level, and hence living apart could split benefits across families and mean that the cap impacts less (or even that neither is subject to a cap). For instance, a couple with three children renting a private property for £300 per week would, after paying their rent, have an income from benefits of £200 per week (compared with around £346 without the cap).

distributional analysis in Section 7.5 models the full-year effects of the cap, i.e. as though it were implemented in full from April 2013.

[78] Source: DWP's Impact Assessment, July 2012 (http://www.dwp.gov.uk/docs/benefit-cap-wr2011-ia.pdf). Note that these estimates were produced before the government announced that it would delay slightly the implementation of the benefits cap in most parts of the country (see footnote 77). The true effect on government revenues in 2013–14 will therefore be slightly smaller than this figure, which should be taken as an estimate of the long-run effect.

[79] As an example, an out-of-work non-disabled lone parent with three non-disabled children claiming Income Support, Child Benefit, Child Tax Credit and Housing Benefit would need to have rent of £196 a week or more to be affected by the cap. A couple in the same circumstances would need to be paying rent of £156 a week or more to be affected. (Source: authors' calculations using TAXBEN and planned benefit rates for 2013–14.)

[80] Source: DWP's Impact Assessment, July 2012 (http://www.dwp.gov.uk/docs/benefit-cap-wr2011-ia.pdf).

[81] For previous research on the effect of financial incentives on fertility, see M. Brewer, A. Ratcliffe and S. Smith, 'Does welfare reform affect fertility? Evidence from the UK', *Journal of Population Economics*, 2011, 25, 245–66.

If they separated, the partner with whom the children lived would still have an income of £200 per week after paying rent. However, the other partner would also be entitled to benefits of at least £71.70 per week after paying their rent. If, instead, one child lived with the second partner, the first partner would still have benefit income of £200 per week and the second partner would now have £161 per week – a combined income 80% greater than if they cohabited. Thus the family-level cap may exacerbate the 'couple penalty' that a family-level benefit system sometimes creates.[82]

The implication behind the cap is that the government believes that the welfare system is too generous to some out-of-work families who are currently able to claim for very large amounts of support due to their high housing costs and/or large numbers of children. However, it is important to recognise that the application of an overall cap on benefit entitlement breaks the link between circumstances and entitlements that the rules of individual benefits imply, at the margin. And yet circumstances and entitlements will remain inextricably linked until benefits reach the level of the cap. The government should consider carefully what it thinks is problematic about current entitlements: there may be better-targeted ways of dealing with the perceived problem via changing the specific benefit rates responsible for overall benefit entitlements that exceed the caps (for example, the amounts that families can claim to cover their rents).

7.5 Distributional impact of tax and benefit reforms in 2013–14

We now present estimates of the overall distributional impact of the reforms planned for 2013–14. We exclude the impact of those reforms in *italics* in Table 7.1, such as the reduction in the main rate of corporation tax, which cannot be allocated to particular households precisely enough with the data available. However, all tax and benefit changes will ultimately affect households, so the figures here must be seen as indicative rather than exact. The changes we are unable to model are, in aggregate, a small net takeaway.[83]

It is important to see the effects of these measures in the context of the tax and benefit changes already introduced during the fiscal consolidation and those planned for the rest of the parliament. We therefore show the estimated impacts of those other reforms – which are much more significant, on average – alongside those of the 2013–14 reforms. In doing so, we also separate the changes that have already happened from those planned for 2014–15 and 2015–16. We model Universal Credit as if it were fully in place in 2015–16 (in reality, it will be only partially rolled out at that point), to give the best possible sense of the long-run effects of the changes.[84]

The estimated distribution of net income under the planned tax and benefit system is compared with the corresponding distribution under a 'counterfactual' system. The

[82] Figures in this paragraph are authors' calculations using TAXBEN and planned benefit rates for 2013–14.

[83] According to published figures, the unmodelled reforms represent a net takeaway of around £0.4 billion in 2013–14, falling to £0.3 billion in the longer term.

[84] We assume that the means tests in the local systems of council tax support alongside Universal Credit in 2015–16 count Universal Credit as income but add rents to earnings disregards. This would leave the devolved governments and English local authorities needing to find cuts elsewhere in their budgets equal to roughly 10% of what Council Tax Benefit expenditure (or, in Northern Ireland, rates rebates expenditure) would have been in that area without the cuts to central government funding for council tax support (see Section 7.4)

counterfactual is a system where tax rates and benefit withdrawal rates remain unchanged from previous years, and benefit amounts and tax thresholds are uprated in line with the public finance defaults inherited by the current government.[85] Because the government has itself changed some of the uprating defaults, the estimated impacts of reforms include the continuing impact of those changes to indexation: the CPI indexation of benefits and tax credits, which began in April 2011; the CPI indexation of some National Insurance thresholds, which began in April 2012; and the 'triple lock' for the Basic State Pension, which began in April 2012.

It is important to note that behaviour and pre-tax prices are held constant in this analysis.[86] This is consistent with HM Treasury's distributional analysis (most recently alongside the Autumn Statement of December 2012), but not with the revenue estimates in Table 7.1, which do allow for some behavioural responses. The analysis is on an entitlements and liabilities basis (for example, it does not account for incomplete take-up of means-tested benefits). This also means that the effects of reforms on incomes are modelled as though taxes are paid when liability accrues, rather than on a National Accounts basis (for example, the changes by and in 2013–14 shown in Figures 7.4–7.6 capture the full long-run impact of adjustments to the higher-rate income tax threshold, even though the government will not actually receive much of the revenue from this until the following year, 2014–15). Again, this is consistent with HM Treasury's distributional analysis but not with the revenue estimates in Table 7.1.

With these caveats in mind, Figure 7.4 shows the distributional impact of the reforms by income decile group. The total monetary gain or loss for each group – income gained or lost plus decreases or increases in indirect taxes paid – is given as a proportion of that group's net income. Households are arranged into decile groups using an equivalised income measure, which accounts for the fact that households of different types need different income amounts to achieve the same living standards. To give a sense of monetary amounts, Table 7.A1 in the annex to this chapter gives the income amounts that example households would need to put them at different points of the income distribution. The cash numbers underlying these proportional gains and losses are also included in the annex.[87] Analysis is presented at the household level.

Figure 7.4 shows that the modelled reforms in 2013–14 are, on average, a net takeaway from lower-income households and a net giveaway to middle- and higher-income households. The various real cuts to benefits and tax credits – including, most significantly, the below-inflation uprating of almost all working-age benefit and tax credit rates (see Section 7.4)[88] – account for the net takeaway within the bottom half of the

[85] See annex A of HM Treasury's June Budget 2010 policy costings document (http://www.hm-treasury.gov.uk/d/junebudget_costings.pdf).

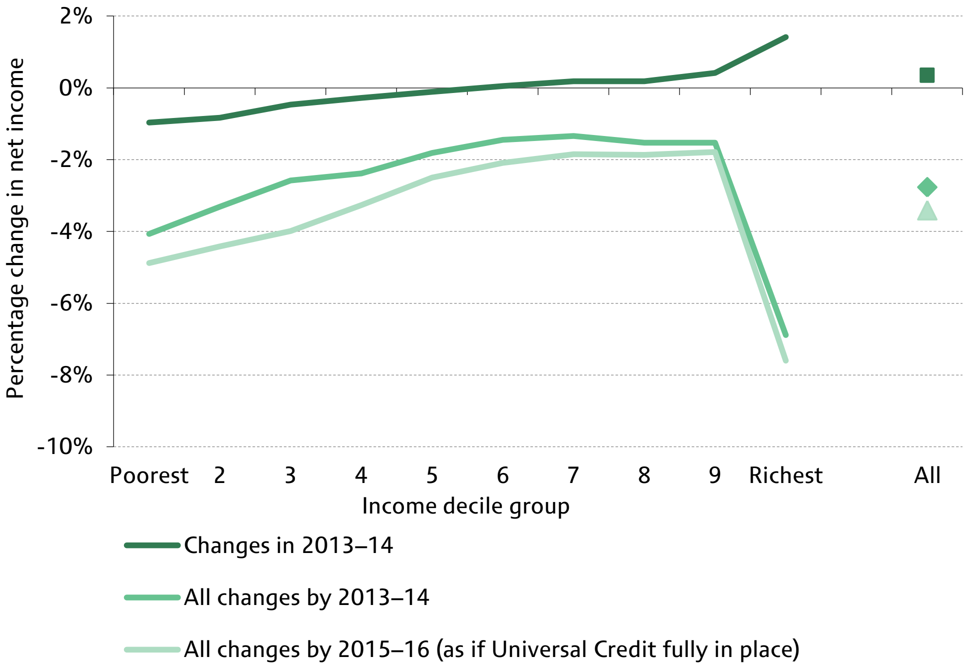
[86] It is probably not realistic that households' behaviour would be completely unaffected by these changes, but this does not mean that incorporating behavioural responses would yield a better impression of the impact on people's welfare. For example, people may move into work in response to lower out-of-work benefit entitlements, but this implies a welfare cost for those individuals as well as the benefit of extra earnings (otherwise they would presumably have chosen to work even before the reform in question). The assumption that pre-tax prices are unaffected by tax and benefit reforms may affect the estimated distributional impacts of those reforms. For example, it implies that retailers fully pass on to consumers the real increases in tobacco and alcohol duty in the form of higher retail prices, but in practice they may not, and the impact of the higher duties may therefore be to reduce shareholder returns or employee wages instead.

[87] Figures 7.A1–7.A4 corresponding to Figures 7.4–7.7.

[88] As mentioned, the counterfactual we use is a policy of RPI uprating of benefit and tax credit rates, although the government has itself changed the default uprating assumption for benefits and tax credits to CPI. We continue to use the pre-consolidation defaults as the counterfactual, so that we can put the measures being implemented in 2013–14 in the important context of all changes over the consolidation as a whole.

income distribution, as this is where the majority of benefit recipients are. The major factor underlying the gains in the upper-middle of the distribution is the substantial above-indexation increase in the income tax personal allowance, which benefits basic-rate income tax payers by £223 per year (see Section 7.3). Those at the very top of the distribution also gain from the reduction in the additional marginal rate of income tax from 50% to 45%.[89]

Figure 7.4. Impact of modelled tax and benefit reforms since January 2010, by income decile group (percentage changes)



Notes: Income decile groups derived by dividing all households into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the lowest-income tenth of households, decile group 2 the second lowest, and so on up to decile group 10, which contains the highest-income tenth. Assumes full take-up of means-tested benefits and tax credits.
Source: Authors' calculations using TAXBEN and Family Resources Survey 2010–11.

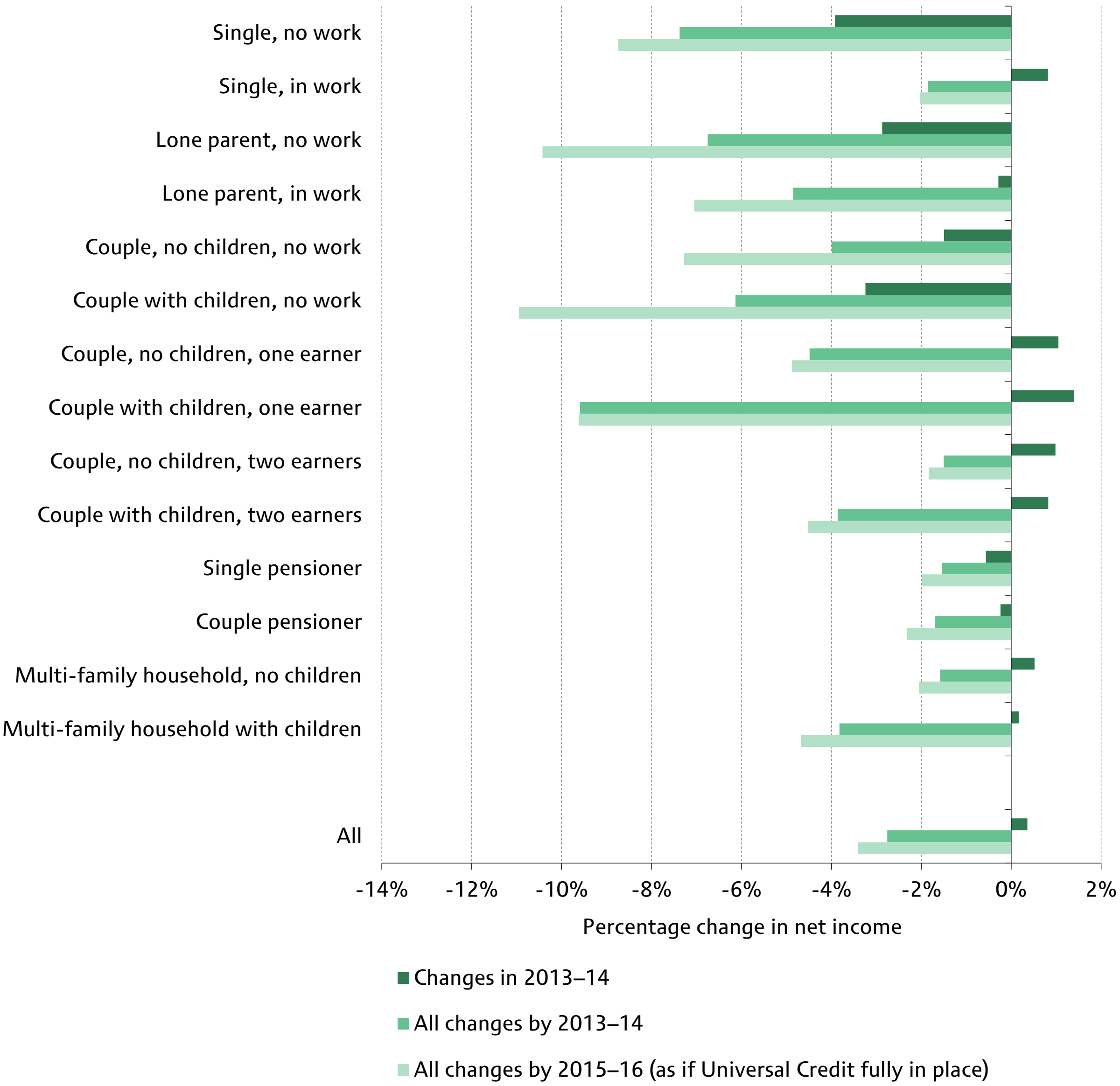
Comparing the impacts of the 2013–14 changes to with those of others implemented or planned during the fiscal consolidation, two striking patterns emerge. First, the increases in taxes and cuts to welfare are substantial overall, but the net effect on households of the reforms being implemented specifically in 2013–14 is small on average despite the large number of changes. The changes being implemented in 2013–14 do not, in aggregate, contribute to the fiscal consolidation, as significant takeaways – such as some of the cuts to benefits – are offset by large giveaways, such as the increase in the personal allowance. Second, those on the very highest incomes have clearly been hit the hardest when looking at the fiscal consolidation as a whole. In addition to real reductions in the higher-rate income tax threshold and rises in National Insurance, the very highest-income individuals have also lost out from the withdrawal of their personal allowance, the introduction of

[89] As with the rest of the distributional analysis, we model the reduction in the top rate of tax as if behaviour is held constant. Note that this gives a lower bound on the welfare gain to those benefiting from the cut – if they change their behaviour, it must be because doing so makes them 'better off' than holding behaviour constant. These gains for those paying the new 45% tax rate are consistent with the statement that there will be little or no exchequer cost of the change (see Table 7.1 and Section 7.3). This is because people may choose to work more (leading to higher income, higher tax revenues and a welfare gain) and spend less effort on complex tax avoidance activity (leading to higher revenues and a welfare gain).

the additional marginal income tax rate, and restrictions to tax relief on their pension contributions. Again, this differs from the pattern observed when looking only at the subset of those measures that will be implemented in 2013–14, which includes a cut in the additional marginal income tax rate to 45% (but this is still higher than the 40% marginal rate that applied over the same range of income before the fiscal consolidation). This highlights the importance of not fixating too much on one year's reforms in isolation.

Nevertheless, over much of the income distribution, the pattern of the impact of the reforms across the income distribution in 2013–14 is similar to the impact of the overall fiscal consolidation package. Those predominantly towards the bottom of the distribution who get a substantial proportion of their income from the state are among the hardest hit, due to welfare cuts; and a group of mostly middle- and upper-middle-income households have benefited particularly from large discretionary increases to the personal

Figure 7.5. Impact of modelled tax and benefit reforms since January 2010, by household type and work status (percentage changes)



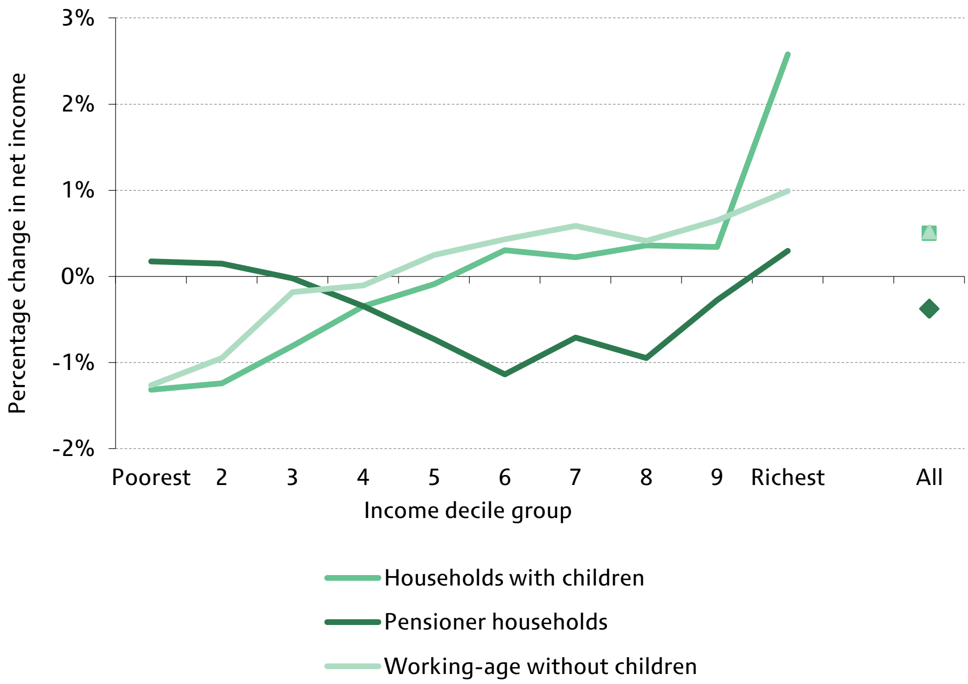
Notes and Source: As for Figure 7.4.

allowance. Note, however, that this analysis captures only the (direct) impacts of changes to tax and benefit policy: middle- and higher-income households have also been among the hardest hit by the failure of earnings growth to keep pace with inflation.

Figures 7.5 to 7.7 give more detail on the patterns of gains and losses. Figure 7.5 shows that in-work households tend to gain, on average, from reforms due in 2013–14. Although many lose from real cuts to in-work welfare (particularly tax credits), most of those also gain from the substantial increase to the income tax personal allowance, and a small high-income group of workers gain from the reduction in the top marginal rate of income tax. Over the consolidation as a whole, in-work households tend to lose more than non-working households, on average, but this is driven heavily by those at the very top of the income distribution who have been hit by substantial tax rises affecting only a small group of people (as made clear by the analysis by income decile group).

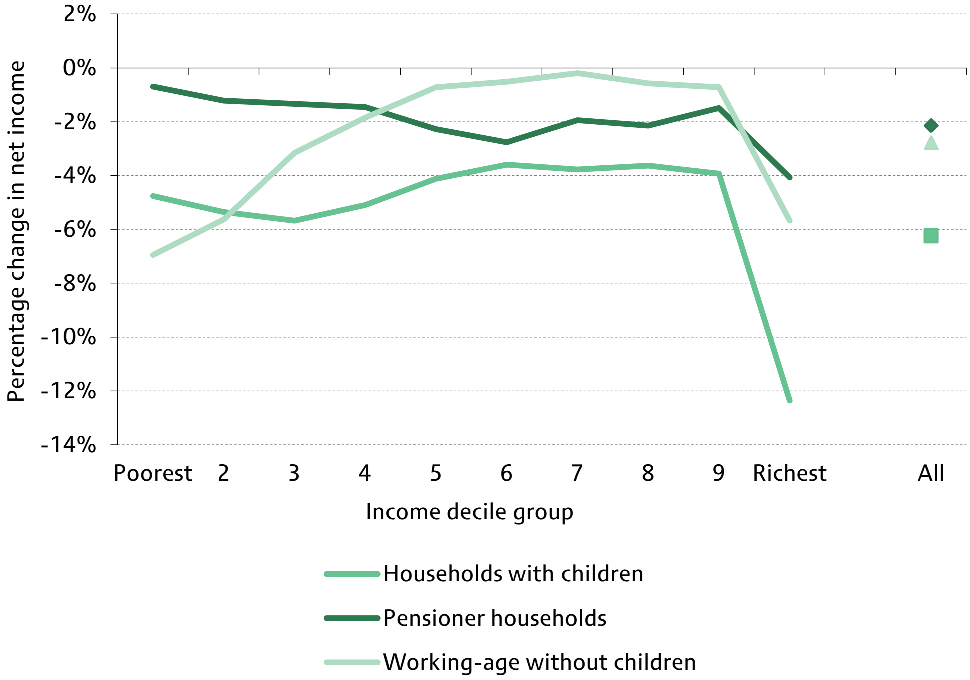
One respect in which the 2013–14 reforms look very different from the consolidation as a whole is that they hit pensioner households more than working-age ones, on average. As Figure 7.6 shows, this is driven largely by the patterns in the middle and upper-middle of the income distribution: that is, where most of the working-age gainers from increases to the personal allowance are, as well as the pensioners who lose from the phasing-out of age-related income tax personal allowances (a tax rise) and the cut to the maximum award in Savings Credit (a benefit cut). At the bottom of the income distribution, though, as with the consolidation as a whole (Figure 7.7), pensioners are largely protected from the broad-based welfare cuts affecting the working-age population in 2013–14, and indeed they gain from the above-indexation increase to the Guarantee Credit element of Pension Credit.

Figure 7.6. Impact of modelled tax and benefit reforms in 2013–14, by income decile group and household type (percentage changes)



Notes and Source: As for Figure 7.4.

Figure 7.7. Impact of modelled tax and benefit reforms between January 2010 and 2015–16, by income decile group and household type (percentage changes)



Notes and Source: As for Figure 7.4.

7.6 Conclusions

The changes to the tax and benefit system being introduced in 2013–14 represent a net giveaway of about £0.9 billion in that year, rising to £1.4 billion in the longer term as temporary measures expire and the full effects of other reforms (such as the introduction of Universal Credit) are felt. Those changes that are directly and immediately incident on households (as opposed to businesses) represent a net giveaway of about £16 per household (£0.4 billion) in 2013–14. But taxes that are formally 'paid by businesses' ultimately have to be paid by households too, either as consumers, employees or shareholders.

The modest net giveaway may come as a surprise, given that it is sandwiched between substantial net takeaways as part of the government's efforts to reduce the budget deficit over this parliament (some of which just came into force in January 2013). It is comprised of significant cuts to income tax for those aged under 65 and cuts to corporation tax, offset by a number of smaller tax increases and a number of cuts to benefit and tax credit spending. Overall, tax measures amount to a net giveaway of £4.2 billion and welfare measures amount to a net takeaway of £3.4 billion. This broad pattern of tax giveaways and welfare takeaways means that the changes taking effect in the coming fiscal year are somewhat regressive, with losses for those towards the bottom of the income distribution, gains for those in the middle and upper-middle of the distribution, and larger gains for those towards the very top of the distribution who benefit from the reduction in the additional rate of income tax from 50% to 45%.

It is crucial to see this one set of changes in the context of a whole raft of reforms since April 2010 (both past and future). Looking at the planned fiscal consolidation as a whole up to 2015–16, those at the very top of the income distribution have tended to lose the most by some distance, both in cash terms and as a percentage of income. The group hit the next hardest are those on working-age benefits, found predominantly towards the bottom of the income distribution, who have lost from the substantial cuts to the working-age welfare budget. Households in the middle and upper-middle of the distribution have tended to lose less than other groups, in no small part because they are the biggest gainers from the substantial increases to the income tax personal allowance.

In aggregate, the tax and benefit reforms coming in during 2013–14 do not contribute to the fiscal consolidation. But they do represent substantial structural changes. The most significant in 2013–14 will be the beginning of the multi-year roll-out of Universal Credit, which will replace six existing means-tested benefits and tax credits. The basic principles behind this have much to commend them, and – if the considerable administrative challenges associated with the move go well – Universal Credit should be a positive reform. But this welcome simplification is being at least partly undermined by the devolution of much of the design and administration of Council Tax Benefit (or rates rebates, in Northern Ireland) to English local authorities and the devolved administrations. The operation of a separate means test that sits outside of the Universal Credit system may lead to awkward interactions with it, weaken work incentives and lead to additional complexity for claimants (particularly since every local authority in England could in principle design a different scheme).

The government should think carefully about how benefits are uprated over time. First, a change in April to the indexation of Local Housing Allowance rates – which set the maximum rents against which private sector tenants can claim Housing Benefit – will have odd effects, such as making future LHA rates depend upon historical local rent levels but not current ones. Second, if the government doubts whether the current default assumption of uprating most benefits and tax credits in line with inflation is the appropriate rule – as suggested by its recent comments on relative patterns of benefits and earnings growth – then it would be helpful for it to clarify its position on what long-run indexation policy should look like. This matters hugely for the future shape of the benefits system and for the public finances. In doing so, the government should bear in mind that a switch to earnings indexation would be likely to increase the level of welfare spending in the long run. And a policy of uprating by the lesser of inflation and earnings growth each year would likely see benefits in the long run grow less quickly than both prices and earnings: although one can always reasonably debate the appropriate level of welfare entitlement, it is not clear why any government should want entitlements to be falling indefinitely over time, both in real terms and relative to general living standards.

On the tax side, the government has clear strategies both in relation to income tax for low earners and for corporation tax, and has stuck to them despite the considerable expense – increasing the personal income tax allowance is a giveaway to most income tax payers aged under 65, not just those on low incomes. But the existence of a strategy does not mean it cannot be improved upon: one simple way of improving the targeting of the government's policy of reducing tax for low earners would be to have raised the threshold for paying National Insurance as well, rather than fixating simply on income tax. Elsewhere, a clear tax strategy is lacking. Perhaps the prime example is fuel duties. These have been cut substantially in real terms under this government at a cost of about £4.7 billion per year. But this has happened in a haphazard way by repeatedly delaying (and eventually cancelling) annual cash-terms uprating that would otherwise have kept duties constant in real terms. That is no way to make tax policy.

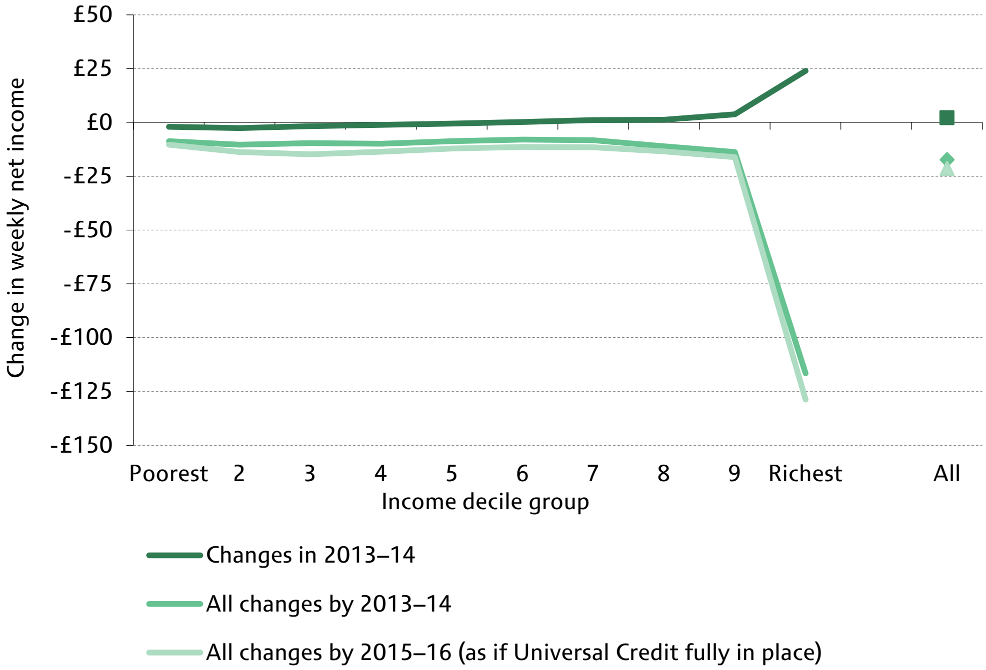
Annex. Monetary amounts underlying distributional analysis

Table 7.A1. Income decile boundary points underlying distributional analysis in Section 7.5: equivalent weekly net income amounts for different household types

	Upper weekly net income limit			
Income decile group	**Couple without children**	**Couple with two children**	**Single without children**	**Lone parent with two children**
1	£267	£390	£163	£286
2	£324	£474	£198	£347
3	£373	£544	£227	£399
4	£426	£621	£260	£455
5	£487	£711	£297	£521
6	£557	£813	£340	£596
7	£642	£937	£392	£687
8	£760	£1,110	£464	£814
9	£998	£1,456	£609	£1,067

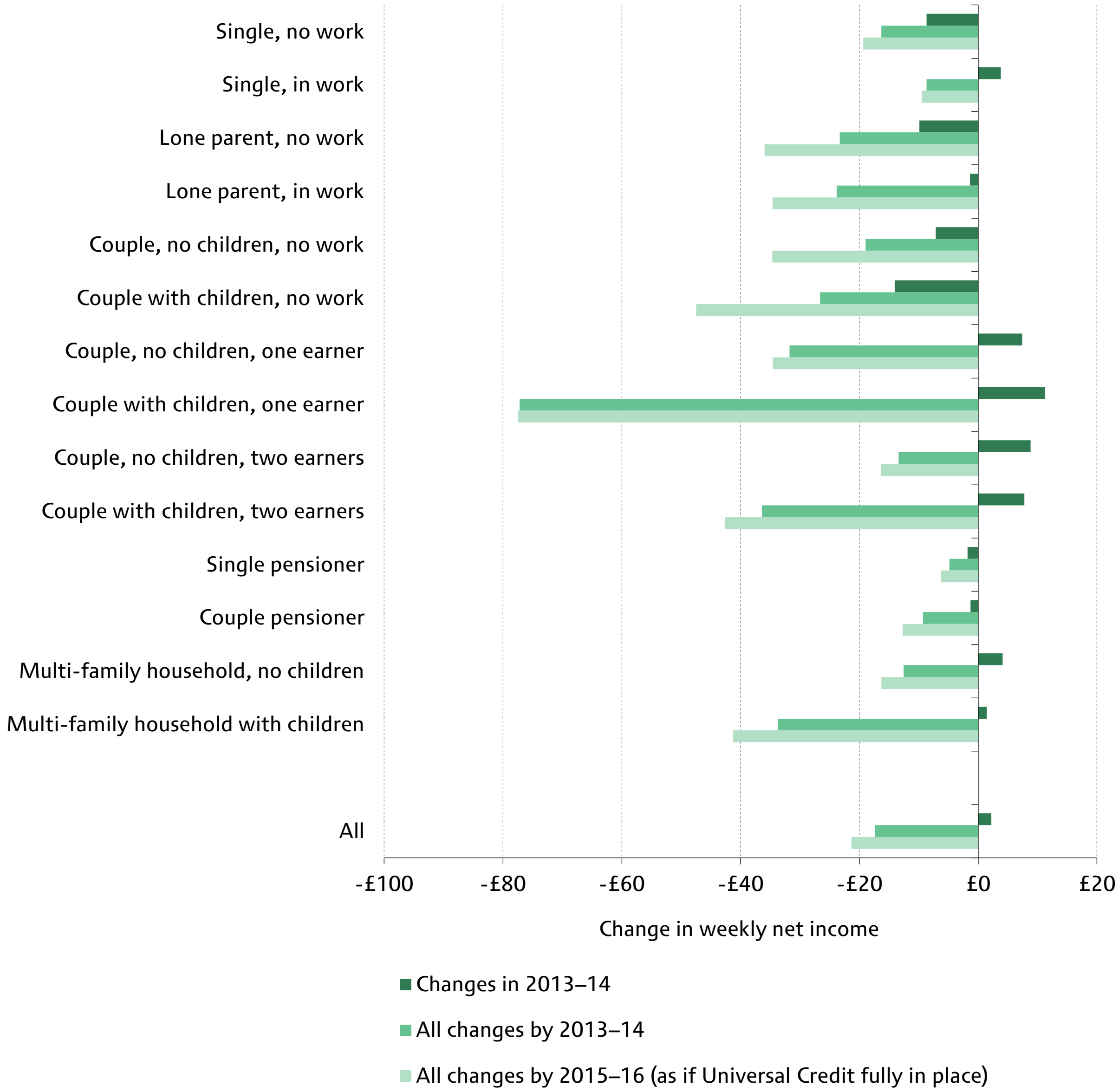
Notes: Based on the McClements equivalence scale, and assumes children are aged 8 to 10 (the scale varies according to the precise age-bands of children).

Figure 7.A1. Impact of modelled tax and benefit reforms since January 2010, by income decile group (cash amounts)



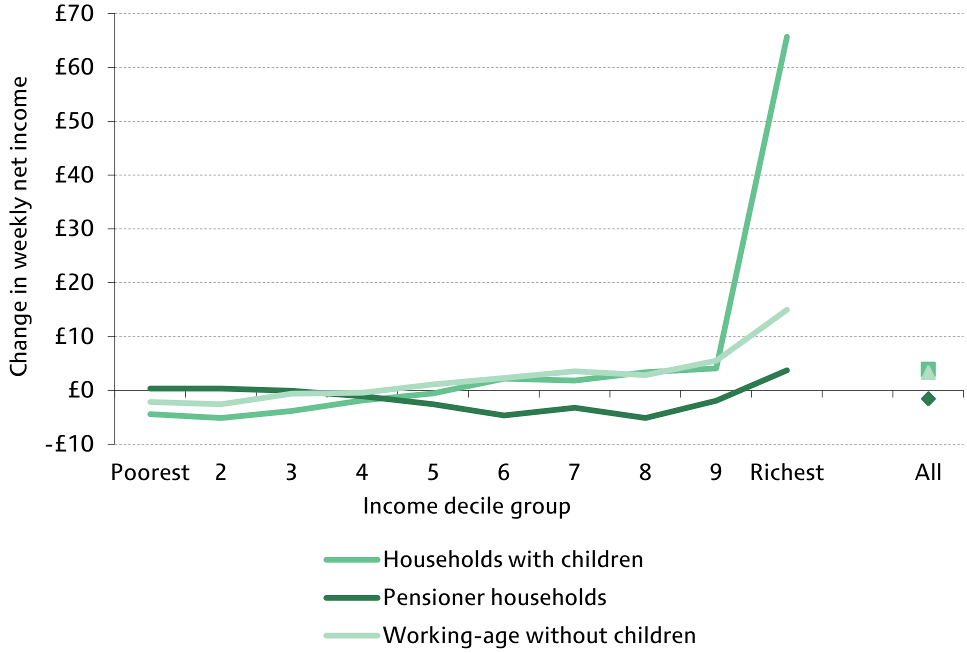
Notes and Source: As for Figure 7.4.

Figure 7.A2. Impact of modelled tax and benefit reforms since January 2010, by household type and work status (cash amounts)



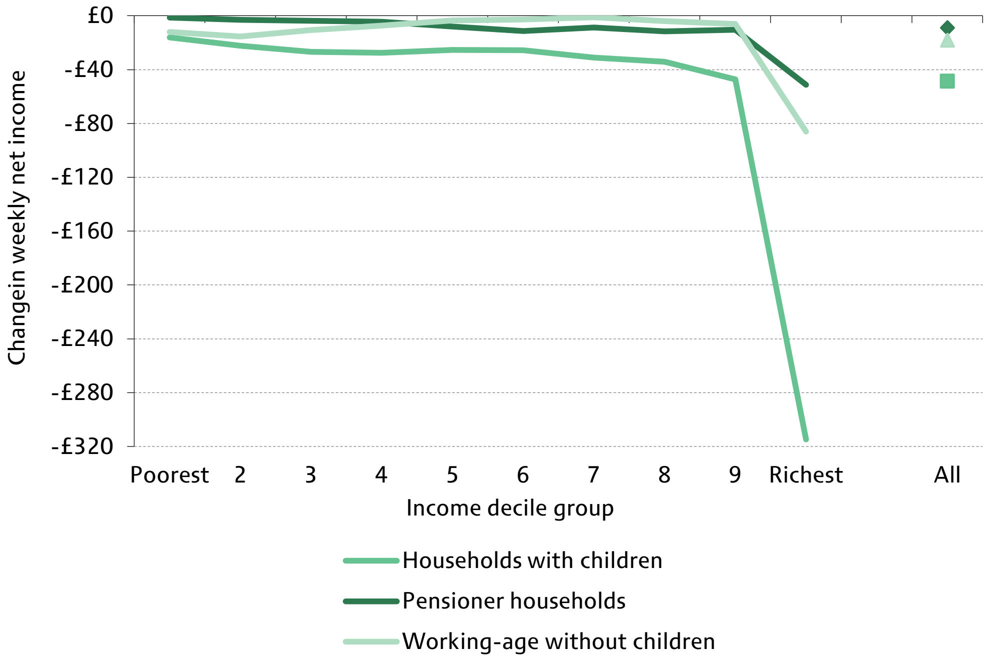
Notes and Source: As for Figure 7.4.

Figure 7.A3. Impact of modelled tax and benefit reforms in 2013–14, by income decile group and household type (cash amounts)



Notes and Source: As for Figure 7.4.

Figure 7.A4. Impact of modelled tax and benefit reforms between January 2010 and 2015–16, by income decile group and household type (cash amounts)



Notes and Source: As for Figure 7.4.