

12. The impact of tax and benefit changes to be implemented in April 2011

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Summary

- Tax and benefit changes to be introduced in April 2011 involve a net ‘takeaway’ of £5.4 billion from households in 2011–12; this is equivalent to £200 per household and comes on top of the £12.8 billion increase in indirect taxes introduced in January 2011, which is equivalent to £480 per household on average.
- Within this net ‘takeaway’, there is an £18.8 billion gross ‘takeaway’ and a £13.4 billion gross ‘giveaway’. Many of these takeaways and giveaways have offsetting effects. This creates a complex pattern of gains and losses from the overall package of reforms.
- The biggest losers are the very richest households, who are particularly affected by the restriction on the amount that can be contributed to a private pension. This comes in addition to the introduction of the 50p income tax rate applying above £150,000 and the withdrawal of the income tax personal allowance above £100,000 that were introduced in April 2010. Working couples with children also lose significantly from cuts to tax credits.
- The main winners from these reforms are non-working lone parents and low- to middle-income households without children. The main factors offsetting the other reforms for these two groups are the increases in the child element of the Child Tax Credit and in the income tax personal allowance respectively.
- The reforms introduced in January 2011 and those to be introduced in April 2011 will slightly weaken the incentive to work at all, on average. However, those on low to middle earnings without children will see their work incentives strengthen because of the increase in the income tax personal allowance.
- On average, the incentive for the vast majority of workers to earn a little more will be slightly weakened as a result of these reforms. Some workers will see their marginal effective tax rates increase more substantially as a result of these changes – the number of individuals paying the higher 40% rate of income tax will increase by 750,000. However, some workers will face a lower marginal effective tax rate as a result of these reforms, in particular those brought out of the income tax and National Insurance systems by increases in the thresholds at which these taxes start to be paid.
- If the government were to meet its aspiration of having a £10,000 income tax personal allowance in 2015–16, this would increase the number of higher-rate taxpayers by a further 850,000 and take another million people out of income tax altogether.

12.1 Introduction

The government's fiscal tightening to fill the structural deficit in the public finances begins in earnest in 2011. The standard VAT rate was increased from 17½% to 20% on 4 January 2011, and significant direct tax, tax credit and benefit changes are due to come into effect in the first week of April 2011. In particular, there will be a net increase in National Insurance contributions (NICs) and cuts to tax credits and Housing Benefit. This will also be the first time that the consumer price index (CPI) rather than the retail price index (RPI) or the Rossi index will be used to uprate most benefits and tax credits (with the most notable exception being the Basic State Pension), which means that they will only increase by 3.1% rather than the 4.6% or 4.8% they would otherwise have done.

In the midst of these reforms, which will tend to reduce household incomes, there will be a few giveaways: the income tax allowance for those aged under 65 will be increased in real terms, and the child element of Child Tax Credit and the Pension Credit guarantee will be increased. This leads to a complicated pattern of winners and losers and impacts on work incentives from the reforms as a whole.

In this chapter, we describe the reforms in more detail and then analyse their effects on the distribution of income and work incentives. Section 12.2 lists the reforms and shows their effects on particular example families, before we examine the overall distributional impact across the income distribution and different household types in Section 12.3. Section 12.4 examines the effect of the reforms on work incentives for current workers and Section 12.5 concludes.

12.2 Tax and benefit changes due in April 2011

Table 12.1 lists the main reforms due to be implemented in the 2011–12 tax year, showing the estimated revenue effects in both 2011–12 and 2012–13.¹ Those in italics are excluded from our analysis of the effects of tax and benefit reforms in Sections 12.3 and 12.4, as they are difficult to attribute to particular households with the data available to us.

There is a net 'takeaway' of around £5.4 billion from tax and benefit reforms to be introduced in 2011–12 (with some additional tax being payable by households in 2012–13 in respect of tax increases that have been imposed in 2011–12). This represents an average reduction in household incomes of around £200 in 2011–12, and comes on top of the increases in VAT, fuel duties and insurance premium tax that were levied in January 2011, which themselves are forecast to raise £12.8 billion, or around £480 per household on average.

¹ We include the revenue effects for both years because the Treasury presents costs on a 'National Accounts' basis, which for most taxes means that revenues are accounted for when liability accrues rather than when revenue is actually received by the government. However, there are important exceptions to this, including corporation tax, self-assessment income tax, inheritance tax and capital gains tax. In these cases, the figures listed for 2011–12 do not record the full impact of the reforms due in 2011–12, as a significant part of the revenue will not be received and accounted for until the following year. For example, it is likely that restricting tax relief on pension contributions in 2011–12 will raise closer to £3.5 billion than £0.2 billion as most of the additional revenue resulting from this change will be received by the Treasury in 2012–13.

Table 12.1. Tax and benefit changes to be introduced in April 2011

	2011–12 revenue effect (£ million)	2012–13 revenue effect (£ million)
<i>Announced by previous government</i>	+£9,360	+£13,950
Income tax		
Freeze basic-rate limit	+£410	+£580
Restrict tax relief on pension contributions	+£200	+£3,500
Freeze annual and lifetime allowances for pension contributions	+£400	+£450
National Insurance		
Increase primary threshold	-£2,930	-£3,090
Increase all rates by 1ppt	+£9,020	+£9,350
Indirect taxes		
Tobacco duty escalator (continues in 2012–13)	+£50	+£100
Fuel duty escalator (continues in 2012–13)	+£490	+£980
Alcohol duty escalator (continues in 2012–13)	+£120	+£240
Tax credits		
Reduce minimum hours of those aged 60 or over to qualify for Working Tax Credit to 16	-£20	-£20
Expiry of one-off giveaways		
Cut in Winter Fuel Payment	+£600	+£600
1.5% real cut in the value of some benefits	+£700	+£700
<i>Other tax and benefit changes</i>	<i>+£320</i>	<i>+£560</i>
<i>Announced in June 2010 Budget</i>	-£4,290	-£3,905
Income tax and National Insurance		
Increase personal allowance, cut the basic-rate limit and increase the upper earnings limit	-£3,490	-£3,700
Increase employer NICs threshold	-£3,130	-£3,150
<i>Relief for new businesses in targeted regions</i>	<i>-£320</i>	<i>-£390</i>
Tax credits		
Reduce second income threshold to £40,000	+£140	+£145
Increase first and second withdrawal rates to 41%	+£640	+£710
<i>Reduce income disregard to £10,000</i>	<i>+£105</i>	<i>+£140</i>
Abolish baby element	+£295	+£275
Increase child element by £150/year above indexation, and £60/year in 2012–13	-£1,200	-£1,845
Housing Benefit		
Link Local Housing Allowance rates to 30 th percentile of local rents	+£65	+£365
Index non-dependent deductions with prices	+£125	+£225
Cap Local Housing Allowance rates and cap maximum allowance at four-bedroom rate	+£55	+£65
<i>Additional bedroom for carers</i>	<i>-£15</i>	<i>-£15</i>
<i>Increase discretionary housing payments</i>	<i>-£10</i>	<i>-£40</i>

Continues

Table 12.1 continued

	2011–12 revenue effect (£ million)	2012–13 revenue effect (£ million)
Other benefits		
Switch to CPI indexation for most benefits and tax credits (also in 2012–13)	+£1,170	+£2,240
Freeze Child Benefit (also in 2012–13)	+£365	+£695
Increase Pension Credit guarantee	–£415	–£535
<i>Abolish Child Trust Fund</i>	+£540	+£550
<i>Abolish Health in Pregnancy Grant</i>	+£150	+£150
Restrict Sure Start Maternity Grant to first child	+£75	+£75
Corporation tax		
<i>Reduce main rate to 27% (and 26% in 2012–13)</i>	–£400	–£1,200
<i>Reduce small companies' rate to 20%</i>	–£100	–£1,000
<i>Introduce bank levy</i>	+£1,150	+£2,320
Capital gains tax		
<i>Increase rate to 28% for higher-rate taxpayers and increase entrepreneurs' relief</i>	+£725	+£825
Council tax		
Freeze	–£625	–£630
<i>Other tax and benefit measures</i>	–£185	–£180
Announced in 2010 Spending Review	+£320	+£370
Freeze maximum Savings Credit award (also in 2012–13)	+£165	+£215
Freeze basic and 30-hour elements of Working Tax Credit (also in 2012–13)	+£195	+£415
Reduce payable childcare costs in Working Tax Credit from 80% to 70%	+£270	+£320
Increase child element of Child Tax Credit by a further £30/year, and another £50 in 2012–13	–£190	–£510
<i>Other benefit measures</i>	–£120	–£70
Total 'giveaway'	–£13,365	–£16,465
Total 'takeaway'	+£18,755	+£26,880
Grand total	+£5,390	+£10,415

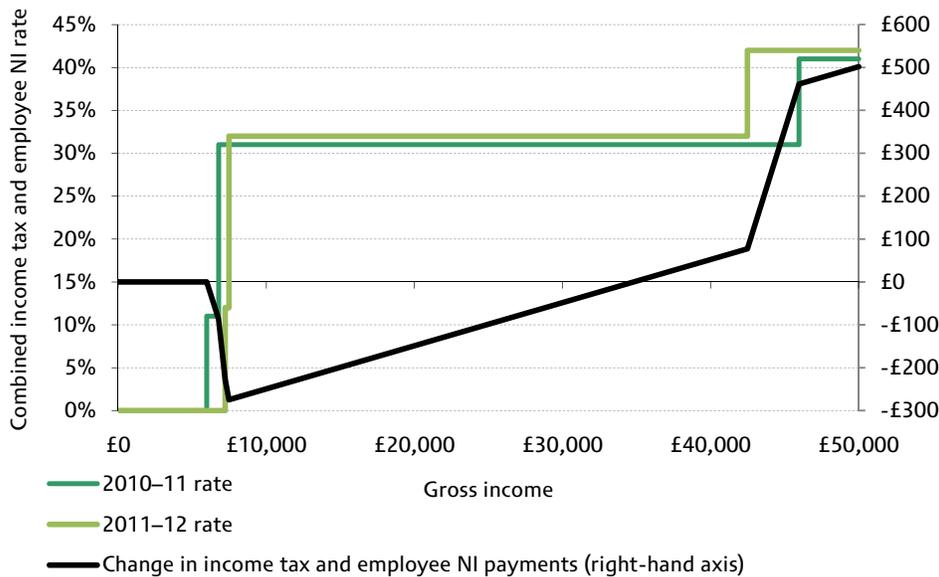
Notes: This table does not include measures already in place as of January 2011 or measures not to be introduced until future years. Where revenue effects also include reforms to be introduced in 2012–13, this is made clear in the table.

Sources: Chapter 2 of HM Treasury, *Financial Statement and Budget Report 2010*, June 2010 (http://www.hm-treasury.gov.uk/d/junebudget_chapter2.pdf), table 3 of HM Treasury, *Spending Review 2010*, October 2010 (http://cdn.hm-treasury.gov.uk/sr2010_completereport.pdf) and table 1.6 of HMRC statistics, *Direct effects of illustrative changes*, http://www.hmrc.gov.uk/stats/tax_expenditures/table1-6.pdf.

Within this net 'takeaway' from households of £5.4 billion, there is a gross 'takeaway' of £18.8 billion and a gross giveaway of £13.4 billion; this is why, as we show in Section 12.3, there are both households that gain from these reforms and households that lose.

However, some of the changes directly offset each other: in particular, the increase in the employee National Insurance (NI) threshold and the income tax personal allowance offset the increase in the employee NI rate. Figure 12.1 examines the impact of changes to income tax and employee NICs on the combined income tax and employee NI schedule in

Figure 12.1. Combined income tax and employee National Insurance schedule in 2010–11 and 2011–12



Note: The figure assumes that all income is earned by an individual aged under the State Pension Age with only one job, with constant earnings throughout the year and who is contracted into the State Second Pension.

Source: Author's calculations.

2011–12, and the gains and losses resulting from these changes.² (These would also be the total gains and losses from the reforms to be introduced in April for an individual aged under 25 without children, or for an individual whose partner's income was too high for their family to be eligible for tax credits; for other individuals, however, reforms to benefits and tax credits will also be important.)

The main differences between the schedules is that, in 2011–12, there are higher allowances before income tax or NI is payable than in 2010–11, but, where income tax and NI are payable, the combined rate is higher. The black line in Figure 12.1 shows that the increases in the income tax personal allowance and employee NI thresholds reduce the amount of income tax and employee NI paid by low earners. The maximum reduction is for an individual earning £7,475 per year (the income tax personal allowance in 2011–12), who will pay around £275 per year less in income tax and NI. However, after this point, the rise in the NI rate reduces this gain until it falls to zero at around £35,000; individuals with earnings greater than £35,000 will pay more income tax and NI as a result of these reforms. The threshold at which an individual starts paying the higher rate of income tax and at which the employee NI rate falls will decrease from £45,975 to £42,475. This is the result of a decision announced by the previous government to freeze the basic-rate limit (the amount of income subject to the basic rate of income tax) and the decision to prevent higher-rate taxpayers benefiting from the increase in the income tax personal allowance announced in the June 2010 Budget. Individuals affected by this latter change see their combined income tax and employee NI rate rise by 10 percentage points. The fall in the higher-rate threshold means that the increase in income tax and NI

² We apply the standard indexation rules to put the 2010–11 system into 2011–12 prices to enable the systems to be compared.

payments rises sharply above £42,475. It will also increase the number of higher-rate taxpayers by around 750,000.³ If the government were to realise its ambition of setting the personal allowance at £10,000 and again wished to prevent higher-rate taxpayers from benefiting from this by reducing the higher-rate threshold, the number of higher-rate taxpayers would increase by a further 850,000, but 1 million people would be taken out of the income tax system altogether.

But this analysis considers only income tax and employee NI for one type of individual. Other reforms will alter the pattern of gains and losses, and whether a particular family wins or loses overall will depend on factors such as the family's income, precise family structure and housing tenure. Another set of reforms that will be particularly important for families with children are those to tax credits and Child Benefit. Again, there are offsetting effects from these changes: the child element of Child Tax Credit will rise, but the values of Working Tax Credit and of Child Benefit will fall in real terms and tax credits will be withdrawn at a faster rate. Figure 12.2 adds these to our previous analysis, where we now take the example of a single-earner family (either a lone parent or a couple) with two children where the earner is working at least 30 hours per week.⁴

This pattern of gains and losses comes about because of the interaction of a number of different reforms to taxes and benefits. In particular:

- A single-earner family with two children earning around the minimum wage will gain from the subset of reforms considered here, because the increase to the child element of Child Tax Credit (CTC) more than offsets the real-terms falls in the value of Child Benefit and Working Tax Credit. The family also benefits from the rise in the income tax personal allowance and employee NI threshold.
- However, as income rises above this point, the gain diminishes and is eventually exhausted at around £18,000.⁵ This is because the individual in question faces a higher marginal effective tax rate (METR) as a result of the increase in both the employee NI rate and the tax credit withdrawal rate. Withdrawing tax credits at a faster rate lowers the point at which this family ceases to be eligible for the child element of CTC from around £31,000 to around £28,000, meaning that the METR falls at a lower gross income point.
- The family element of Child Tax Credit will be withdrawn from £40,000 rather than £50,000 in 2011–12, and at the higher rate of 41% rather than 6²/₃% as it is in 2010–11. This means that the METR for this individual returns to 73% between £40,000 and around £41,300 instead of remaining at 31%. Around 175,000 workers will see their METRs increase from below 40% to above 70% as a result of this change. The loss for families with incomes between £41,300 and £50,000 increases by the value of the family element of CTC, £545 per year, as a result of this change, on top of the loss caused by the increase in the employee NI rate and the freeze in Child Benefit.

³ Source: Author's calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on 2008–09 Family Resources Survey.

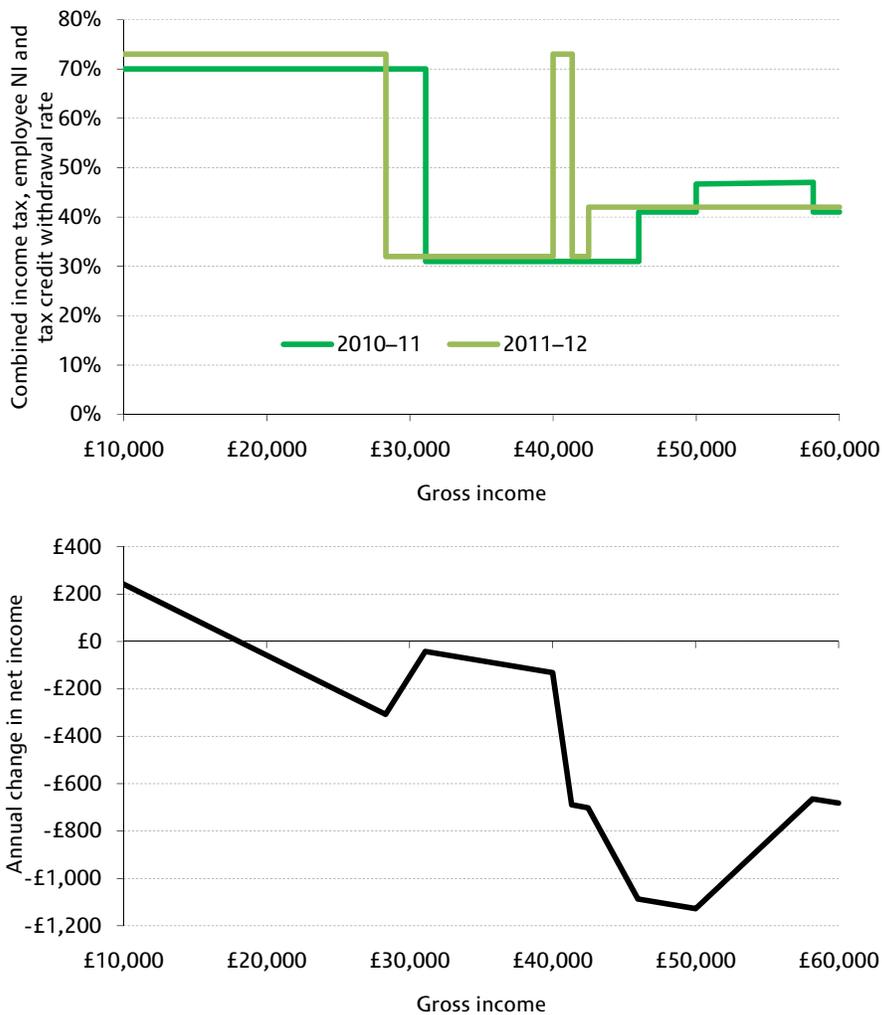
⁴ Note that we have therefore started this chart at £10,000 since we are assuming that the individual works at least 30 hours per week and this is approximately the amount earned from 30 hours' work at the minimum wage.

⁵ The equivalent figure is £14,000 for a one-child family and £22,000 for a three-child family.

- Families with incomes greater than £50,000 lose less than this from the earlier withdrawal of the family element, as they currently receive less than the full family element of CTC. This loss becomes zero at the point where tax credit entitlement ends under the current system, £58,175, but families with incomes greater than this still lose out from the freeze in Child Benefit rates and the increase in the employee NI rate.

In Section 12.3, we expand our analysis to take account of reforms to all means-tested benefits and indirect taxes, and look at average losses across the income distribution and for different family types.

Figure 12.2. Combined income tax, employee National Insurance and tax credit withdrawal schedule for a lone parent or single-earner couple with two children, and change in income resulting from reforms to income tax, employee National Insurance, tax credits and Child Benefit



Note: The figure assumes that all income is earned by an individual aged under the State Pension Age working at least 30 hours per week with only one job, no childcare costs and constant earnings throughout the year and who is contracted into the State Second Pension.

Source: Author's calculations.

12.3 The distributional impact of the tax and benefit changes due in April 2011

In this section, we show the distributional impact of the reforms listed in Table 12.1, excluding those in italics which cannot be precisely allocated to particular households with the data available (either because they directly affect households in ways that we cannot model precisely – such as the fall in the within-year earnings disregard in tax credits – or because they do not directly affect households – such as a fall in the main rate of corporation tax – although households will be affected in some way through all of these tax and benefit changes). Unmodelled measures (those in italics) represent a net ‘takeaway’ of around £1.8 billion in 2011–12, or around £70 per household on average. (This is made up of a gross ‘takeaway’ of £3.2 billion and a ‘giveaway’ of £1.4 billion.) Separately, we also show the effects of the indirect tax rises introduced at the beginning of January 2011.

The counterfactual to which we compare these reforms is a system where tax and benefit withdrawal rates remain unchanged from their levels in January 2011, and benefit amounts and tax thresholds are uprated in line with the public finance defaults set down by the previous government.⁶ Our analysis is done at the household level.

It is important to note that throughout this section, we hold behaviour and pre-tax prices constant.⁷ This is consistent with HM Treasury’s analysis published in the June 2010 Budget and the October 2010 Spending Review, but not with the costings in Table 12.1 which do allow for some behavioural response. It is probably not realistic that households’ behaviour would be unaffected by these tax and benefit changes, but it is not clear that incorporating behavioural responses would make the distributional analysis a better guide to the impact on people’s well-being. For example, the extra effort of working harder bears a cost for the individual as well as bringing the benefit of extra earnings – otherwise they would presumably have chosen to work even before the reform in question. Section 12.4, which shows the impact of reforms on work incentives, gives some guide to the likely labour supply responses.

Our assumption about not allowing pre-tax prices to alter in response to changes in tax and benefit reforms is clearly more plausible in some cases than in others, and this may have consequences for the distributional effect of reforms. For example, we assume that retailers fully pass on to consumers the increase in VAT that took effect in January 2011, but in practice they may not be able to, which may instead reduce shareholder returns or employees’ wages. We assume that cuts to Housing Benefit are fully incident on tenants, but in practice landlords may reduce rents in response to reductions in the generosity of Housing Benefit, meaning that they would see their incomes reduced rather than Housing Benefit claimants. It is also the case that the rise in VAT is likely to increase the value of inflation used by the government to adjust benefits, tax credits and tax allowances in April 2012. However, we do not think that it would be helpful to allow for this in our assessment of the impact of changes to taxes and benefits on household incomes, for two main reasons:

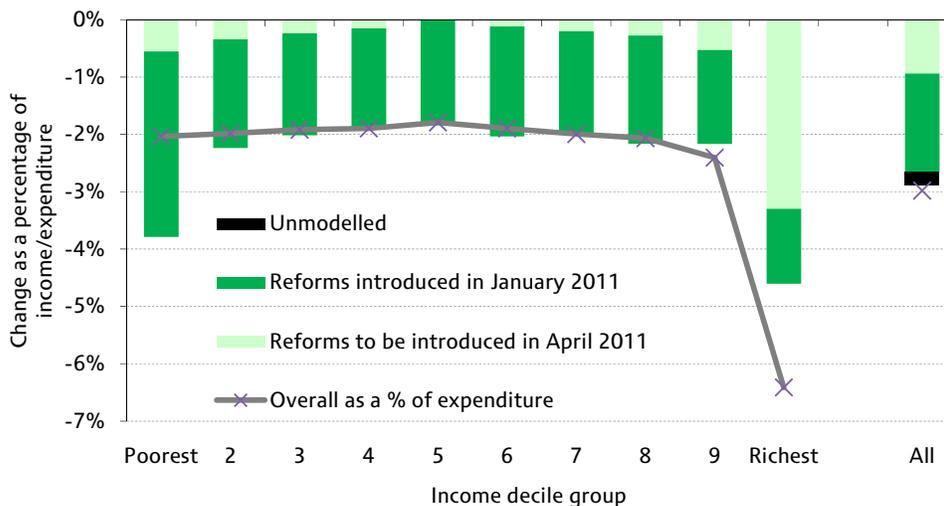
⁶ This generally means RPI indexation for tax thresholds, tax credit rates and non-means-tested benefit rates and Rossi indexation for means-tested benefit rates.

⁷ The only exception to this is that we assume that employers reduce wages in response to increases in employer NICs so as to keep the total employer cost constant. This means that employee and employer NICs have an identical incidence in our results, which is what we would expect from economic theory.

- First, if we were to allow for this knock-on effect of higher inflation, consistency would require us to allow for other knock-on effects of inflation. For example, some employees will have wages or salaries that are contractually linked to measures of inflation, and some private pension payments and other forms of unearned income are automatically linked to measures of inflation. It is not possible therefore for us to model precisely the impact of higher inflation on household incomes, and so the most consistent and transparent approach is to hold the pre-tax price level constant.
- Second, it is relatively straightforward to assess the impact of a VAT rise on inflation (though there is some question as to how far firms will pass on the VAT rise to customers in higher prices). But many other tax and benefit reforms could affect inflation in ways that are much harder to assess. Similarly, the VAT increase and other policies could affect a much wider range of economic outcomes, ranging from employment rates to exchange rates. It would be impossible for us to incorporate all the knock-on economic effects of all reforms into a distributional analysis. Rather than selectively incorporate some effects of some policies, but not others, we believe that the most consistent and transparent approach is to estimate the direct – almost ‘arithmetical’ – effect of reforms on different households holding all other aspects of the economy constant.

Bearing these caveats in mind, Figure 12.3 shows the distributional impact of reforms to be introduced in April 2011 by income decile group, and the impact of the reforms that were introduced in January 2011. We express the total income loss for each income decile group as a proportion of its net income and as a proportion of its expenditure. The average effect of the reforms that we are unable to allocate to particular households is shown in the ‘all’ bar and labelled ‘unmodelled’.

Figure 12.3. Distributional impact of reforms introduced in January 2011 and to be introduced in April 2011 by income decile group



Notes: Income decile groups are derived by dividing all households into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth. Assumes increases in employer NICs are passed on to employees in the form of lower wages.

Source: Author’s calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2008–09 Family Resources Survey and 2008 Expenditure and Food Survey.

The tax and benefit reforms to be introduced in April 2011 reduce the incomes of each tenth of the income distribution, but they cause the biggest losses as a fraction of net income at the top and the bottom. This pattern of income changes cannot be described as progressive or regressive. The pattern arises because households at the bottom of the income distribution lose out particularly from the lower benefit rates that arise from using the CPI to uprate benefits rather than the RPI or the Rossi index, and because these households often do not benefit from the increases in the income tax personal allowance and NI threshold. It is households in the middle of the income distribution which benefit the most from these increases in tax and NI thresholds as a percentage of income. Households at the top of the income distribution lose out from the increase in NI rates and, in the case of the very richest households, the restriction on the maximum amount that can be invested in a private pension each year.

Adding in the increases in VAT and fuel duty that were introduced in January 2011 does not significantly alter the distributional pattern when losses are expressed as a proportion of expenditure (see Box 12.1), but does substantially increase the scale of the losses. The average loss from all of these measures (introduced in both January 2011 and April 2011, modelled and unmodelled) is around 2.9% of income.

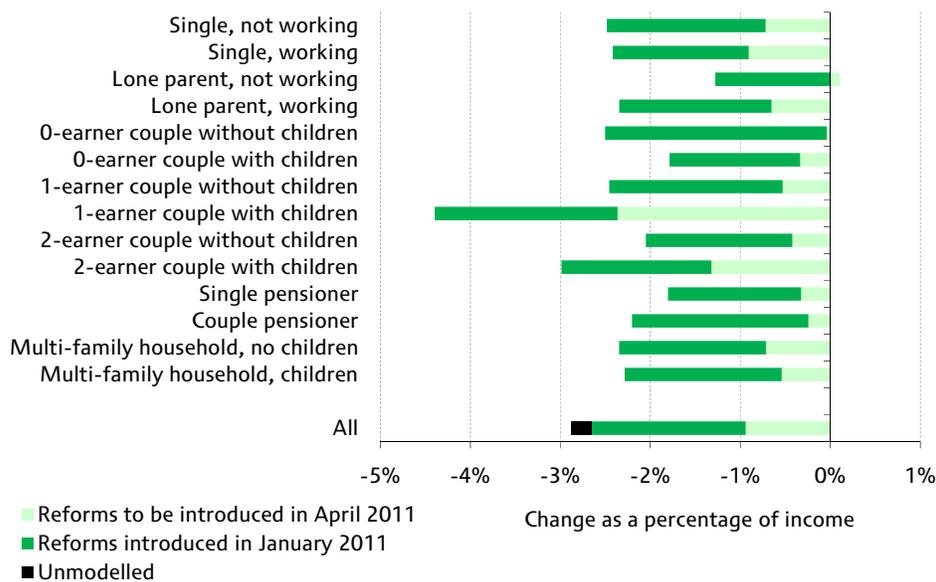
Box 12.1. The distributional impact of increasing the standard VAT rate

Figure 12.3 shows that the increases in indirect taxes in January 2011, which are dominated by the increase in VAT to 20%, seem to be regressive, in the sense that lower income decile groups lose more as a percentage of net income than those higher up the income distribution. This largely comes about because some households that report low incomes at a point in time to the household surveys that we use in our modelling also report relatively high levels of expenditure, which would suggest they will experience large losses from increases in indirect taxes. But many of these households are not those that we would ordinarily think of as being poor: consider, for example, the self-employed with volatile earnings, those who are temporarily unemployed, students, those taking a break from the labour market to raise children, pensioners with large amounts of capital, and so on. All such households will have low incomes when observed in a snapshot, but may be able to maintain higher living standards. However, over a lifetime, income must equal expenditure (ignoring inheritances and bequests), so households that are spending more than their income at a point in time must be saving or drawing down debt at another time, and therefore losing less as a proportion of their income from an increase in indirect taxes at this time.

Taking a lifetime perspective, what matters is whether the lifetime-rich or the lifetime-poor see a larger share of their lifetime resources taken in VAT, and on that basis VAT is progressive because necessities (consumed disproportionately by the lifetime-poor) are typically subject to zero or reduced rates of VAT. Indeed, when we instead rank households by current expenditure rather than current income, we see that low-spending households (which we might consider to be the lifetime-poor) spend proportionately less on items subject to the standard rate of VAT.^a

a. See, for example, T. Crossley, D. Phillips and M. Wakefield, 'Value added tax', in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2009*, IFS Commentary 107 (<http://www.ifs.org.uk/budgets/gb2009/09chap10.pdf>).

Figure 12.4. Distributional impact of reforms introduced in January 2011 and to be introduced in April 2011 by household type



Note: Assumes increases in employer NICs are passed on to employees in the form of lower wages.
 Source: Author's calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2008–09 Family Resources Survey and 2008 Expenditure and Food Survey.

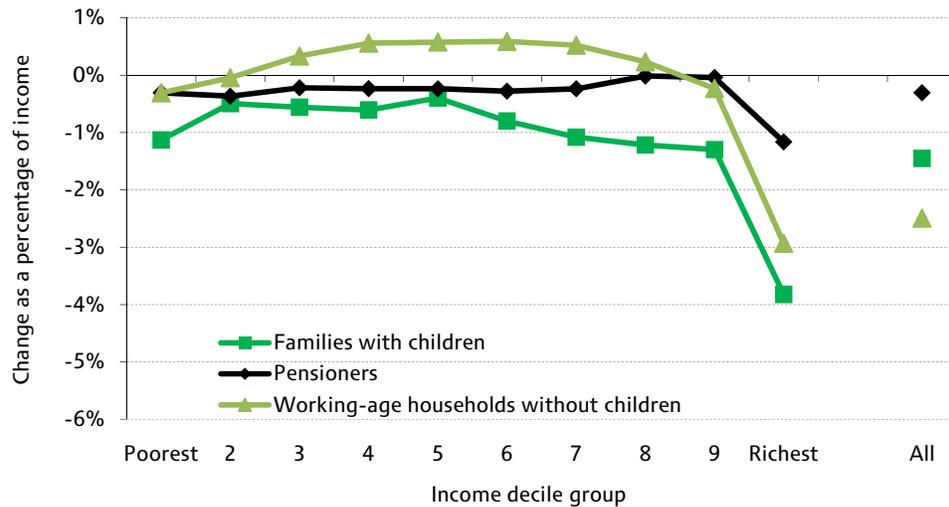
Figure 12.4 shows how the overall pattern varies by different types of household. The only household type to gain on average from the reforms to be introduced in April 2011 is non-working lone parents. They gain because the increase in the child element of CTC offsets the cuts to other benefits (cuts relative to the indexation rules in force under the previous government), and they are not affected by the increase in NI rates. Family types that lose by relatively small amounts on average are non-working couples and pensioners. By contrast, working couples with children are the most affected group: they lose from the more aggressive means-testing of tax credits and the rise in NI rates. The very richest households, which are affected by the restriction of tax relief on pension contributions, are also disproportionately found in this group.

Finally, Figures 12.5 and 12.6 show the average loss as a percentage of income for households with children, pensioners and working-age households without children in each decile group of the income distribution, both excluding (Figure 12.5) and including (Figure 12.6) the impact of the increases in indirect taxes in January 2011.

The pattern of losses across the income distribution is similar for families with children, pensioners and those of working age without children, with bigger losses amongst the richest and poorest households than amongst those in the middle of the income distribution. However, within each tenth of the income distribution, it is families with children who are most affected. This is because they are the group that is principally affected by the cuts to tax credits. By contrast, working-age households without children that are in the middle of the income distribution gain, on average, from the reforms to be introduced in April 2011. This is because they benefit from the increases in the income

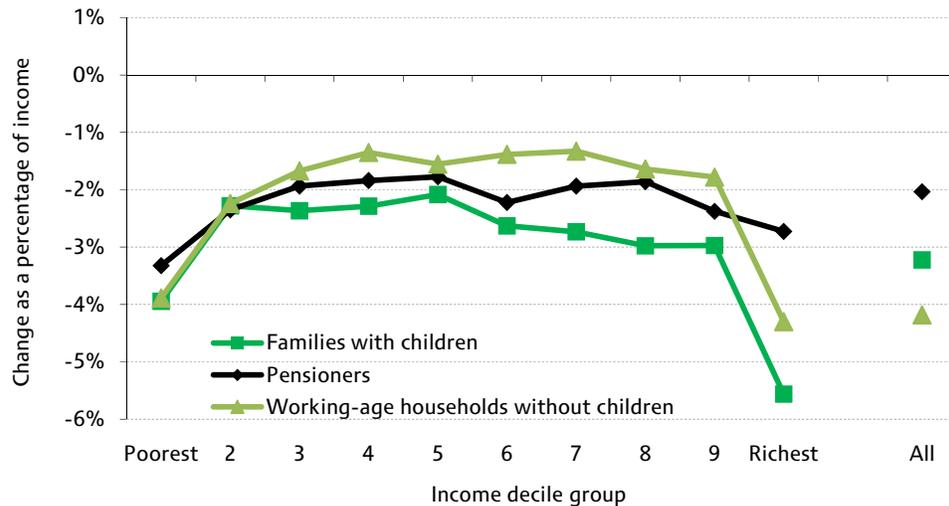
tax and NI thresholds, and are much less affected by cuts to benefits and tax credits.⁸ Pensioner households lose as a result of the fall-back in the level of the Winter Fuel Payment but are not affected by the increase in NI rates (except for those whose partner is below the State Pension Age). None of these conclusions is significantly altered when we include the increases in indirect taxes that were implemented in January 2011 (Figure 12.6), except that all family types in all decile groups are now worse off, on average.

Figure 12.5. Distributional impact of reforms to be introduced in April 2011 by decile group and family type



Notes: As for Figure 12.3.
Source: As for Figure 12.3.

Figure 12.6. Distributional impact of reforms introduced in January 2011 and to be introduced in April 2011 by decile group and family type



Notes: As for Figure 12.3.
Source: As for Figure 12.3.

⁸ Note, however, that, on average across the income distribution, working-age households without children lose more as a percentage of income than families with children. This can be explained by the fact that working-age households without children are disproportionately found in higher income decile groups, whereas those with children are disproportionately found in the lower income decile groups.

12.4 The impact on work incentives

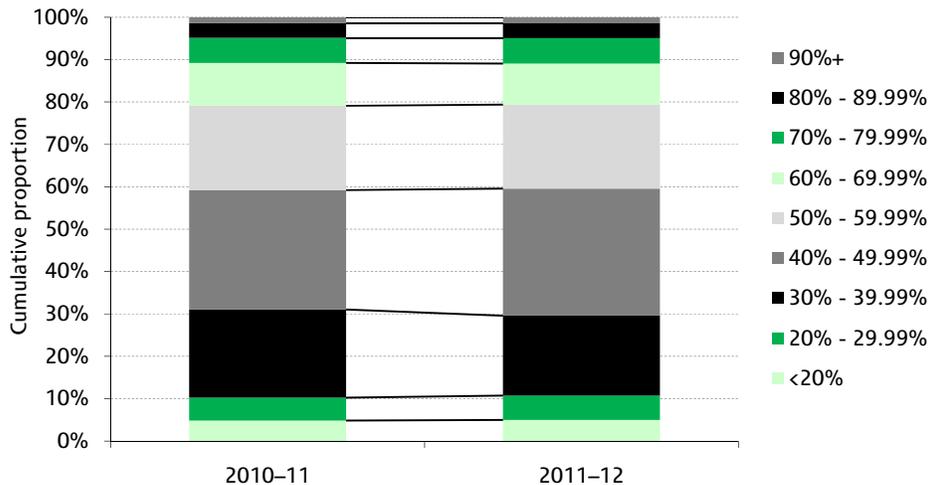
In this section, we examine the impact of the reforms to be introduced in April 2011 on work incentives. We distinguish between the incentive to do paid work at all, as opposed to not working, and the incentive for a worker to increase their earnings slightly.

The incentive to work at all

Our measure of the incentive for an individual to work at all is the participation tax rate (PTR). This measures the proportion of earnings that is taken in higher taxes or lower benefit entitlements when an individual moves into work. We would expect the reforms to have offsetting effects on the incentive to work at all. Less generous uprating of out-of-work benefits and increases in the income tax and NI thresholds would be expected to strengthen the incentive to work at all, whereas increases in NI rates and more aggressive means-testing of tax credits would tend to weaken incentives.

Figure 12.7 shows the distribution of PTRs under an uprated version of the April 2010 tax and benefit system and under that due to be in place in April 2011. We only include current workers in this analysis. We include employer NICs and indirect taxes in our calculations of PTRs. Indirect taxes are important for work incentives, as presumably the attractiveness of working depends on the quantity of goods and services that can be purchased with the wage earned, meaning that a tax that reduces earnings will have much the same effect as one that increases prices. We calculate a consumption tax rate for each household before and after the reforms based on its observed consumption patterns. The size of each slice of the bars in the chart represents the proportion of workers whose PTRs are in each range under the system in question.

Figure 12.7. Participation tax rates of workers before January 2011 and in April 2011



Notes: Calculations are for personal taxes and benefits only: excludes most 'business taxes' (notably corporation tax and business rates, though not employer NICs) and capital taxes (notably inheritance tax, stamp duties and capital gains tax). Only includes those in work.

Source: Author's calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2008 Expenditure and Food Survey.

The reforms introduced in January 2011 and to be introduced in April 2011 will very slightly weaken the incentive to work at all on average. The mean and median PTR will both increase by 0.1 percentage points. However, there will be some workers for whom work incentives will strengthen – around 11.2 million workers will see their PTRs fall, compared with 16.6 million who will see them rise. In particular:

- Those with children will see their work incentives weaken on average: this is because cuts in the real value of the Working Tax Credit and the increase in the tax credit withdrawal rate will reduce the income they receive when they are in work, whereas the increase in the child element of the Child Tax Credit will increase the amount of income they would receive if they were not working.
- However, those without children on low to middle earnings will see their incentive to work at all strengthen. This is because the increases in the income tax personal allowance and the employee NI threshold will increase the amount of income they would receive were they to work, whereas using the CPI to uprate out-of-work benefit rates will reduce the amount of income they would receive were they not to work.
- Those without children on high incomes will see the amount of income they receive when working fall because the increase in the employee NI rate more than offsets the increase in the NI threshold, and the fall in the threshold at which the higher 40% rate of income tax becomes payable means that they do not benefit from the increase in the income tax personal allowance. Therefore, PTRs for this group will increase, on average.

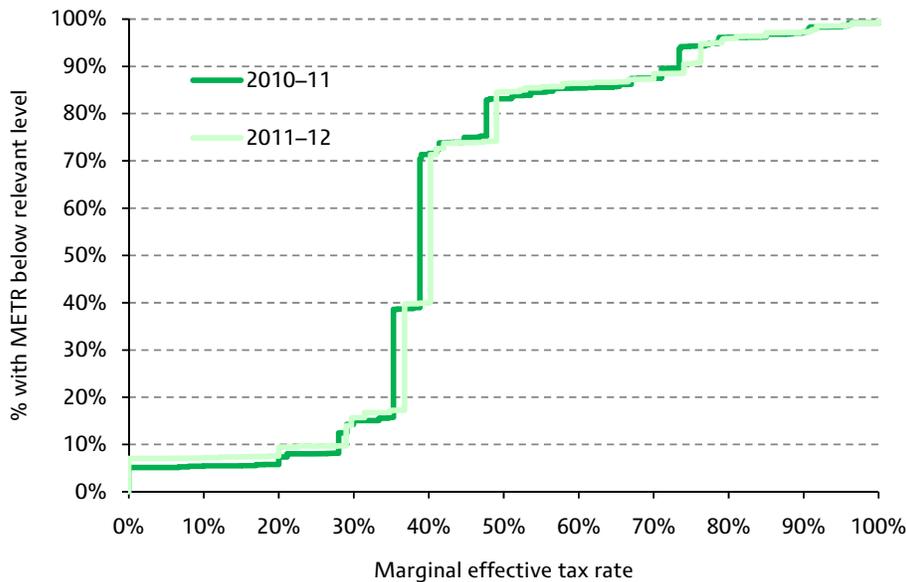
The incentive to earn more

Our measure of the incentive for an individual to earn more is the marginal effective tax rate. This measures the proportion of a small rise in earnings that is lost through higher taxes or lower benefit entitlements. In Figure 12.8, we show the effect of the changes to be introduced in April on METRs amongst those already in work. Note that in this chart we exclude indirect taxes for the sake of clarity (since each household in our sample has a different average consumption tax rate), although we mention figures including indirect taxes in the following discussion.

The tax and benefit reforms to be introduced in April 2011 will increase METRs for most workers. Overall, 2.8 million workers see their METRs fall as a result of these changes, 22.4 million see a rise (although generally only a small one) and 2.2 million are unaffected. The mean METR rises by 0.3 percentage points and the median by 1.4 percentage points. When we include the reforms to indirect taxes, including those introduced in January 2011, the mean METR rises by 1.1 percentage points and the median by 1.9 percentage points.

The main cause of the rise in METRs is the increase in NI rates, which takes METRs from 38.8% to 40.2% (or 31% to 32% excluding employer NI) for a basic-rate taxpayer who is contracted in to the State Second Pension and from 35.3% to 36.8% (or 29.4% to 30.4% excluding employer NI) for an individual who is contracted out. For higher-rate taxpayers, the METR increases from 47.7% to 49.0% (or 41% to 42% excluding employer NI). The increase in the tax credit withdrawal rate further increases the METR faced by a basic-rate taxpayer who also faces tax credit withdrawal; including the NI rise, the overall METR will rise from 73.4% to 76.3% (or from 70% to 73% excluding employer NI) for such a person.

Figure 12.8. Cumulative distribution of METRs before and after reforms to be introduced in April 2011 (workers only)



Notes: Excludes indirect taxes and most ‘business taxes’ (notably corporation tax and business rates, though not employer’s NI) and capital taxes (notably inheritance tax, stamp duties and capital gains tax).
 Source: Author’s calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2008–09 Family Resources Survey.

There are also some individuals whose METR falls as a result of these reforms. Some of these are workers who have been brought out of income tax and NI by increases in the personal allowance and NI thresholds: for example, the number of workers whose METR is zero increases by nearly 500,000 as a result of these reforms. Other individuals who see their METRs fall are those who are no longer entitled to tax credits as a result of them being means-tested more aggressively; this reduces the number of workers with METRs of 70% or more by around 250,000. This nicely illustrates the ambiguous impact that changing the withdrawal rate of a means-tested benefit has on a measure of work incentives: increasing a benefit withdrawal rate increases the METR for those who remain entitled to that benefit, but reduces it for those who lose entitlement as means-testing extends less far up the income distribution.

12.5 Conclusion

The tax and benefit reforms that will be introduced in April 2011 consist of a ‘takeaway’ of £18.8 billion and a ‘giveaway’ of £13.4 billion, making a net ‘takeaway’ from households of £5.4 billion. Many of these takeaways and giveaways have offsetting effects but, despite this, there will be some winners as well as losers from the reforms.

The main winners will be low- to middle-earning households without children and non-working lone parents, and the biggest losers will be working couples with children and, in particular, the very richest households.

The April 2011 reforms, when considered alongside the increases in indirect taxes that were introduced in January 2011, slightly weaken work incentives on average, although

the increases in the income tax personal allowance and NI thresholds are sufficient to strengthen the incentive for individuals to work in some cases.

Of course, there are other reforms that are due to be implemented in April 2012 or later, and the effect of reforms such as multiple-year benefit freezes and the move to CPI indexation increases in magnitude over time. In particular, cuts in annual welfare spending will total £18 billion by 2014–15, compared with only £2.3 billion in 2011–12, which will disproportionately affect poorer households.⁹ In the longer term, the government wishes to introduce the new Universal Credit system which will benefit low-income working families and strengthen incentives to work for most groups (although not second earners in couples).¹⁰ These reforms will both have at least as great an impact as the reforms discussed in this chapter.

⁹ Sources: Table 2.1 of HM Treasury, *Financial Statement and Budget Report 2010*, June 2010 (http://www.hm-treasury.gov.uk/d/junebudget_chapter2.pdf) and table 3 of HM Treasury, *Spending Review 2010*, October 2010 (http://cdn.hm-treasury.gov.uk/sr2010_complereport.pdf).

¹⁰ See J. Browne, 'Distributional impact of tax and benefit changes', presentation at IFS 2010 Spending Review briefing, 21 October 2010 (<http://www.ifs.org.uk/publications/5313>) and M. Brewer, J. Browne and W. Jin, 'Universal Credit: a preliminary analysis', IFS Briefing Note 116, 2011 (<http://www.ifs.org.uk/bns/bn116.pdf>).