

Tax and Benefit Changes: Who wins and who loses?

ELECTION BRIEFING 2005

SERIES EDITORS: ROBERT CHOTE AND CARL EMMERSON

Stuart Adam
Mike Brewer
Matthew Wakefield

The Institute for Fiscal Studies

Tax and benefit changes: winners and losers

Stuart Adam, Mike Brewer and Matthew Wakefield*

Summary

- Tax and benefit changes implemented by Labour since 1997 will have a net cost to the exchequer of around £2.2 billion in 2005–06. The average (mean) impact of this small net giveaway is to raise household disposable incomes by £1.69 a week or 0.4%. The biggest proportionate gains are in the 2nd poorest tenth of the population, whose disposable incomes are increased by 11.4%, while the richest tenth fare worst, with a cut in income of 3.7%.
- Tax and benefit reforms since 1997 have clearly been progressive, benefiting the less well-off relative to the better-off. Reforms in the second term – while less generous on average – were more progressive than those in the first, with the poorest faring better.
- Increases in council tax above inflation since 1997 will raise £5.8 billion in 2005–06, net of council tax benefit. This outweighs the giveaway by central government, and leaves households overall £2.85 a week worse off on average, equivalent to 0.6% of their disposable incomes. The increase in council tax is regressive, except for the poorest fifth of the population, who are partially protected from the rises by council tax benefit.

1 Introduction

This Briefing Note shows how tax and benefit reforms since 1997 have affected both government revenues and the incomes of different groups in the population. It updates previous IFS analysis published in early 2005 by including the tax and benefit changes announced in the 2005 Budget.¹

* Special thanks are due to Christine Frayne for help with the analysis in Section 2.

¹ The previous work analysed reforms announced in or before the 2004 Pre-Budget Report, and can be found in chapter 7 of R. Chote, C. Emmerson, D. Miles and Z. Oldfield (eds), *The IFS Green Budget: January 2005*, IFS, London, 2005 (<http://www.ifs.org.uk/budgets/gb2005/05chap7.pdf>).

2. The scale of fiscal changes since 1997

Estimates of the implications of tax and benefit reforms since 1997 for the public finances in 2005–06 are reported in Table 1 (see the Appendix and the Notes to the table for precise details).

Table 1. Revenue effects in 2005–06 of changes to taxes and benefits implemented by central government since 1997

	Revenue raised for exchequer		
	1997–2001	2001–2005	Total
Total income tax	£3.1bn	£1.0bn	£4.2bn
<i>Of which:</i>			
Married couple's allowance	£3.7bn	£0.0bn	£3.7bn
Income tax rates and personal allowances	–£7.3bn	£0.1bn	–£7.2bn
Dividend tax credits	£7.3bn	£0.0bn	£7.3bn
Total National Insurance contributions	–£2.0bn	£8.7bn	£6.7bn
<i>Of which:</i>			
Employee contributions	–£2.0bn	£4.1bn	£2.2bn
Employer contributions	–£1.5bn	£4.1bn	£2.6bn
Total indirect taxes	£4.7bn	–£0.1bn	£4.6bn
<i>Of which:</i>			
VAT	–£0.8bn	£1.0bn	£0.2bn
Tobacco taxation	£2.3bn	£0.0bn	£2.3bn
Alcohol taxation	–£0.2bn	–£0.0bn	–£0.2bn
Insurance premium tax	£0.4bn	£0.0bn	£0.4bn
Road fuel duties	£4.0bn	–£0.8bn	£3.2bn
Vehicle excise duty	–£1.1bn	–£0.3bn	–£1.4bn
Total stamp duties	£2.4bn	£0.5bn	£2.9bn
<i>Of which:</i>			
Introduction of higher rates for properties	£2.2bn	£0.0bn	£2.2bn
Increase zero-rate threshold to £120,000	£0.0bn	–£0.3bn	–£0.3bn
Total corporation tax	–£4.8bn	£2.9bn	–£1.9bn
<i>Of which:</i>			
Changes to rate structure	–£4.5bn	–£0.5bn	–£5.0bn
Total change in cost of benefits / tax credits	–£10.5bn	–£9.1bn	–£19.6bn
<i>Of which:</i>			
Mortgage interest relief at source	£3.8bn	£0.0bn	£3.8bn
Personal tax credits ^a	–£6.4bn	–£4.1bn	–£10.5bn
Child benefit (and child trust fund and non-attributable child-based reforms)	–£1.9bn	–£0.2bn	–£2.1bn
Pensioners' package (winter allowance, basic state pension and minimum income guarantee increases, pension credit, etc.)	–£5.0bn	–£4.2bn	–£9.2bn
Overall total	–£6.5bn	£4.2bn	–£2.2bn

^a These are working families' tax credit (WFTC), disabled person's tax credit (DPTC), child tax credit (CTC) and working tax credit (WTC).

For further notes, see next page.

Notes to Table 1: All costings have been reflatd to 2005–06 prices using nominal GDP growth published by the Office for National Statistics and (for projections) HM Treasury. The totals include all measures, not just the taxes and benefits costed in detail in the table. Some taxes and benefits have been reformed more than once since May 1997, which means that they may score as both exchequer gains and exchequer losses.

The figures in the detailed breakdowns in this table are approximate. In some instances, it is not possible to break down the cost of measures introduced into the categories given in the table. For example, increases to child premiums in both income support and WFTC are often grouped together in costings published by the Treasury. In such cases, the effect of the changes is either attributed to the category deemed likely to be responsible for the greater part of the cost, or added to child benefit (and non-attributable child-based reforms). The difficulty with separating the effects of some measures also explains why WFTC, DPTC, WTC and CTC are considered as one category.

The authors thank Chris Frayne for her help in analysing numbers from FSBRs and PBRs in order to compute the numbers in this table.

Sources of Table 1: HM Treasury, *Financial Statement and Budget Report* and *Pre-Budget Report*, various years.

Over the entire period, the net effect of all policy changes to the tax and benefit system is a small fiscal loosening of £2.2 billion (around 0.2% of national income) compared with what the government's budgetary position would have been had the May 1997 system simply been uprated in line with the conventional public finance assumptions (further important details about the way these numbers have been calculated are given in the Appendix). This relatively small figure is actually the difference between a large set of revenue-raising reforms (around £57.5 billion) and a slightly larger set of costly reforms (around £59.7 billion): the small net effect does not therefore preclude a substantial distributional impact, as we will see in the next section. Comparing total effects across each parliament, the net effect of measures implemented before 2001 is a giveaway of £6.5 billion this year, but measures implemented since 2001 are set to raise a net £4.2 billion for the exchequer this year.

3. A distributional analysis of fiscal reforms since 1997

This section allocates the fiscal changes since 1997 to different households.

The starting point is to simulate what the tax and benefit systems that existed at the times of the 1997 and 2001 general elections would have looked like now if there had been no policy reforms since, and to compare those with the actual system in force today. We then use the IFS tax and benefit micro-simulation model, TAXBEN, to calculate taxes due and entitlements to benefits on the same data on incomes, expenditures and demographic characteristics of households at a given point in time.

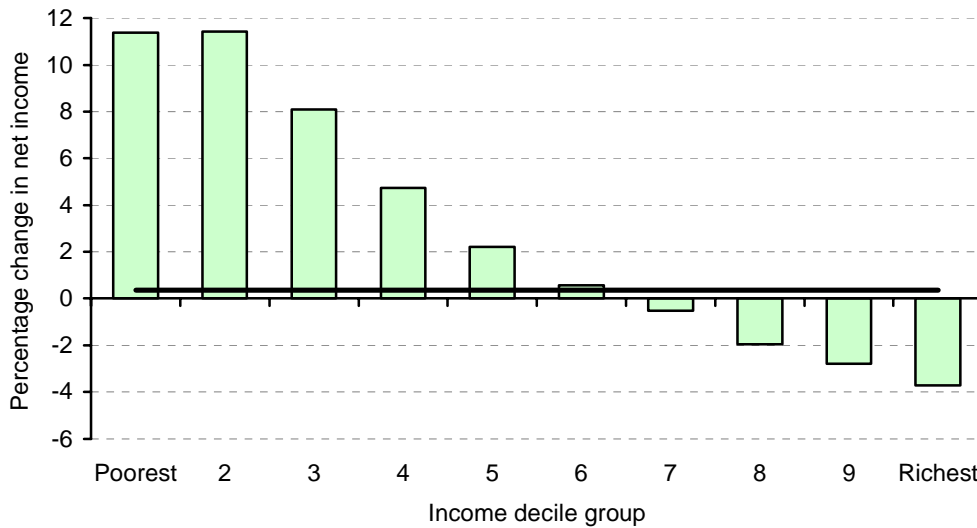
The combination of the costs of making applications and lack of information means that many people do not claim means-tested benefits and tax credits to which they are entitled. TAXBEN models households' entitlement to programmes, not their actual receipt. The implication of this for our analysis is discussed in section 7.3 of *The IFS Green Budget: January 2005*; the conclusion is that we cannot be sure of the size or even the direction of any bias this may induce in our estimates.

However, there are a number of measures that we cannot allocate to specific households in this way. These are predominantly certain taxes levied on businesses and on non-labour income, which are hard to allocate to particular households because patterns of stock ownership through institutions such as unit trusts and pension funds make it very difficult to

know how share ownership and dividend incomes are distributed across the population, and therefore to whom we should allocate such taxes. But simply excluding any reforms to these taxes from our assessment of the distributional effects of Labour’s tax and benefit reforms could create a misleading impression: all taxes are ultimately paid by individual households. As a crude solution, therefore, we assume that the tax and benefit changes not modelled in TAXBEN have an equal proportionate impact on all households.² This process also means that any difference between the net effects given in Table 1 and the net effects modelled in TAXBEN are allocated proportionately to income.

Figure 1 shows the estimated effect in 2005–06 of all tax and benefit reforms introduced by central government since 1997 across the income distribution. It excludes council tax, which is set by local authorities and is discussed in the next subsection. The net £2.2 billion giveaway corresponds to an average of £1.69 per household per week, or 0.4% of households’ disposable incomes (the black line in Figure 1). However, the size of the change varies widely across the income distribution: the biggest gains are experienced by the 2nd poorest tenth of the population, who gain an average of £27.53 per week, or 11.4% of their net incomes; the biggest losses are experienced by the richest tenth, who lose on average £43.14 per week, or 3.7% of their incomes.

Figure 1. Gains and losses across the income distribution from fiscal reforms since 1997 (excluding impact of council tax changes)

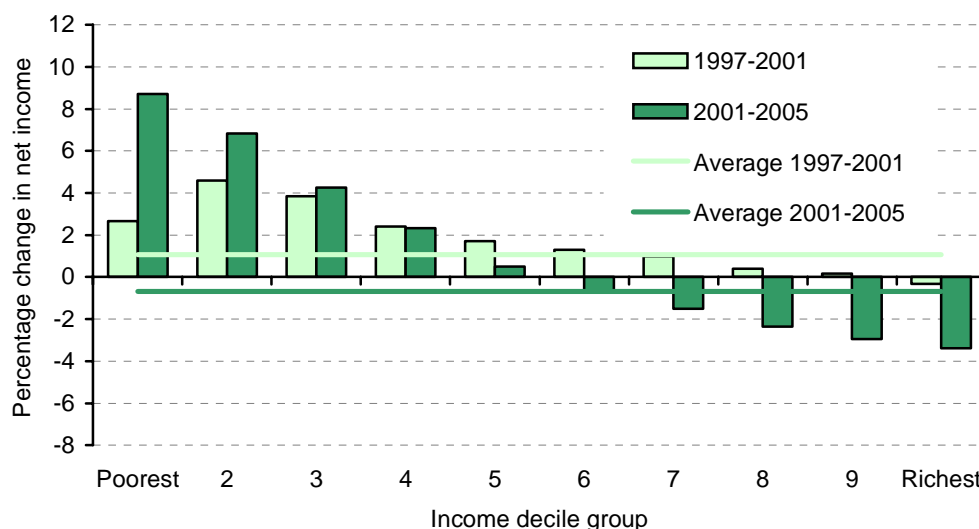


Note: Income decile groups are derived by dividing all households into 10 equal-sized groups according to net income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the 2nd poorest, and so on up to decile group 10, which contains the richest tenth.

Sources: IFS tax and benefit model, TAXBEN, run using updated data from the 2003–04 Family Resources Survey and the 2001–02 Expenditure and Food Survey; authors’ calculations using the British Household Panel Survey; Table 1.

² Changes to stamp duty on residential properties are allocated in a different way; for a description, see section 7.3 of R. Chote, C. Emmerson, D. Miles and Z. Oldfield (eds), *The IFS Green Budget: January 2005*, IFS, London, 2005 (<http://www.ifs.org.uk/budgets/gb2005/05chap7.pdf>).

Figure 2. Gains and losses across the income distribution from fiscal reforms in the 1997 and 2001 parliaments (excluding impact of council tax changes)



Note: See Figure 1.

Sources: See Figure 1.

Table 2. Gains and losses for different household types from fiscal reforms since 1997 (excluding impact of council tax changes)

Household type	Percentage change in net income (%)	Average change in net weekly income (£)
Single, not working	-2.44	-3.97
Single, working	-3.18	-12.11
Lone parent, not working	13.45	32.42
Lone parent, working	10.14	36.94
0-earner couple, no children	-1.57	-5.48
0-earner couple, children	14.91	48.91
1-earner couple, no children	-3.38	-18.02
1-earner couple, children	2.24	13.06
2-earner couple, no children	-3.41	-22.73
2-earner couple, children	-1.37	-9.60
Single pensioner	10.72	23.23
Couple pensioner	4.00	15.79
Multi-family household, no children	-1.30	-8.33
Multi-family household, children	1.86	12.99
All non-pensioners without children	-2.57	-13.22
All non-pensioners with children	1.89	10.78
All pensioners	6.88	20.08
All	0.36	1.69

Note: Multi-family households treated as non-pensioners in the more aggregated groups.

Sources: See Figure 1.

Figure 2 breaks down the overall changes between the impact of measures implemented in Labour's first and second terms. As we showed earlier, Labour's first-term reforms entail a net gain to households in 2005–06 of £6.5 billion (£4.93 per household per week, on average, or 1.1% of disposable incomes) whereas the second-term reforms entail a net loss to households of £4.2 billion (£3.24 per household per week, or 0.7% of incomes). As a result, most decile groups gain less, or lose more, from Labour's second-term reforms than from its first-term reforms. However, the bottom three decile groups actually gain more from Labour's second-term reforms than from its first-term reforms. Thus, even as the government took money away from households overall in its second term, it gave money to those on the lowest incomes at an even faster rate than in its first term.

Table 2 shows how the changes since 1997 affect different household types on average in 2005–06. There is a pattern of losses on average for working adults without children, and of gains on average for lone parents, non-working households with children and pensioners.

Council tax

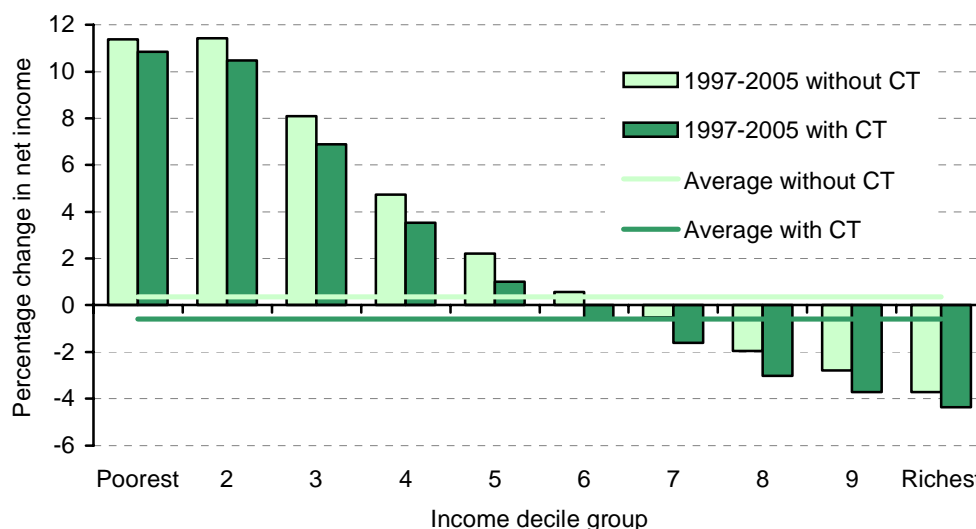
Council tax (net of council tax benefit) will make up an estimated 4.3% of government revenues in 2005–06, up from 3.9% in 2001–02 and 3.5% in 1997–98. So far, this Briefing Note has ignored council tax because the rates are not set directly by central government. But central government grants and demands on local authorities heavily influence local authorities' decisions, and council tax rises are tax changes that affect households' disposable incomes, so there is a case for including council tax changes in the analysis.

We compare actual rises in council tax with a counterfactual 'no change' baseline in which all council tax rates rise in line with inflation.³ Actual rises have been substantially above inflation in both parliaments, with average real increases in England and Wales of around 4.1% per year between April 1997 and April 2001 and 5.2% per year between April 2001 and April 2005. We estimate that these increases will raise £5.8 billion in 2005–06, net of any consequential effect on council tax benefit: this is an average loss to households of £4.54 per week or 1.0% of their disposable income, and is enough to make the average net effect on household incomes of all changes since 1997 negative.

The effect of this across the income distribution is shown in Figure 3. All decile groups lose from real increases in council tax rates. On average, council tax rates rise less quickly than income as we move up the income distribution, so for the most part the percentage loss of income is smaller for each successively higher income group (although the reverse is true in cash terms). The exception to this is the bottom two income decile groups, which are less affected by the inclusion of council tax since many of these households have their council tax bills partly or wholly covered by council tax benefit (although we exaggerate this here by assuming full take-up of council tax benefit).

³ More precisely, rising each April in line with the change in the retail prices index for the year to the previous September.

Figure 3. Gains and losses across the income distribution from fiscal reforms since 1997, with and without council tax



Note: See Figure 1.

Sources: See Figure 1.

Whether or not council tax is included in the analysis, the broad picture remains the same: Labour's tax and benefit reforms since 1997 will have relatively little effect on average household incomes in 2005–06, but this conceals substantial redistribution from high-income households to low-income households and from childless workers to lone parents, non-working parents and pensioners.

Appendix. Main details of our methodology

What is a change to a tax or benefit, and what does it cost?

This Briefing Note considers only changes to taxes, benefits and tax credits; we do not attempt to allocate spending on public services to particular households.

For the measures that we do allocate to households, we estimate what their effects on government revenues and household incomes in 2005–06 are likely to be. This means that we compare the actual tax and benefit system now in place with the tax and benefit system that would have been in place today in the absence of any of the reforms. This comparison tells us what the cumulative effect of Labour's reforms will be on households in 2005–06. It does not, therefore, measure changes in revenues – and corresponding changes in household incomes – *during* the period. We ignore altogether reforms whose direct effects were felt entirely before 2005–06, such as the windfall tax and the abolition of advance corporation tax. Whether measures were introduced early or late in a parliament is also irrelevant for our analysis, since we do not take account of how many years households have benefited/lost from them.

In estimating the effects of various tax and benefit reforms, we have to decide what exactly constitutes a reform – in other words, what would constitute a 'no change in policy' baseline with which we could compare the actual 2005–06 tax and benefit system. Our revenue estimates are derived from reforms and costings listed in various Budgets and Pre-Budget

Reports, and therefore measure changes relative to the ‘no change’ assumptions made in the public finance forecasts. These provide for some cash rates and thresholds to increase in line with a range of measures of inflation (with various rounding rules applied) and for others to remain fixed in cash terms. We follow this practice throughout this Briefing Note, so that we have the same costings for reforms as the government; this also allows us to interpret these costs as (roughly) the change in the fiscal position and the income distribution that would result from reversing them. But public finance assumptions have no special economic status, and in some cases are quite arbitrary. One alternative would be to interpret ‘no change’ as meaning all cash rates and thresholds increasing in line with (a single measure of) inflation. Another would be to interpret ‘no change’ to mean cash rates and thresholds increasing in line with growth in the tax base: income tax thresholds in line with taxable incomes, corporation tax thresholds in line with taxable profits, stamp duty thresholds in line with the total value of housing transactions in the economy, and so on. This latter option would mean counting fiscal drag – the increase in revenues that results from the tax base increasing faster than tax thresholds – as a reform. In fact, the Treasury estimates that the fiscal drag implied by the definition of ‘no change in policy’ in the public finances increases government revenues by 0.2% of national income a year: in other words, ‘no change’ as the Treasury (and we in this Briefing Note) use the term is consistent with a substantial fiscal tightening.⁴

Allocating tax/benefit payments to households

In apportioning different taxes and benefits to particular households, we use the notion of a household’s ‘tax payment’.⁵ This is the sum of the tax levied on all spending by household members and that levied on the incomes received by household members, minus any benefits or tax credits that they receive. Thus:

- Taxes on the expenditures of households, such as VAT, excise duties and stamp duty on house purchases, should be allocated to the household making the purchase.
- Taxes on income from labour supplied, including both employee and employer National Insurance contributions, should be allocated to the worker’s household.
- Taxes on the return to capital, such as income tax on savings and dividends, capital gains tax and corporation tax, should be allocated to the household owning the capital, which has the right to the income stream on which the tax is levied.

In Section 3, we use the IFS tax and benefit micro-simulation model, TAXBEN, to allocate tax payments to households. We simulate what the tax and benefit systems that existed at the times of the 1997 and 2001 elections would have looked like in 2005 if there had been no policy reforms since. TAXBEN applies these two counterfactual tax and benefit systems, along with the actual 2005 system, to the same data on incomes, expenditures and demographic characteristics of households at a given point in time in order to calculate the tax payments implied by the different systems for each household. This procedure ignores any

⁴ Paragraph A.24 of HM Treasury, *End of Year Fiscal Report*, December 2003 (http://www.hm-treasury.gov.uk/media/324/70/end_of_year_352%5B1%5D.pdf).

⁵ This terminology and many of the ideas here are due to A. Dilnot, J. Kay and M. Keen, ‘Allocating taxes to households: a methodology’, *Oxford Economic Papers*, 1990, vol. 42, pp. 210–30. The notion of a ‘tax payment’ does not correspond exactly to either formal or effective incidence.

changes in households' behaviour (quantities purchased, labour supplied, etc.) that might occur because of differences between the tax and benefit systems, and this means that we must be cautious about how literally we interpret our results as measuring the welfare effects of reforms: households' well-being depends on many factors, including the amount that they consume, the number of hours that they work, and any costs of time, effort or stigma associated with claiming benefits and tax credits.

The combination of such costs of making applications and lack of information means that many people do not claim means-tested benefits and tax credits to which they are entitled. TAXBEN models households' entitlement to programmes, not their actual receipt. The implication of this for our analysis is discussed in section 7.3 of *The IFS Green Budget: January 2005*; the conclusion is that we cannot be sure of the size or even the direction of any bias this may induce in our estimates.

In addition to this, there are a number of measures that we cannot allocate to specific households using TAXBEN. These are predominantly certain taxes levied on businesses and on non-labour income, which are hard to allocate to particular households because patterns of stock ownership through institutions such as unit trusts and pension funds make it very difficult to know how share ownership and dividend incomes are distributed across the population, and therefore to whom we should allocate such taxes. Simply excluding any reforms to these taxes from our assessment of the distributional effects of Labour's tax and benefit reforms could create a misleading impression: all taxes are ultimately paid by individual households. As a crude solution, therefore, we assume that the tax and benefit changes not modelled in TAXBEN have an equal proportionate impact on all households.⁶ By allocating any difference between the net effects given in Table 1 and the net effects modelled in TAXBEN in this way, we also allocate proportionately to income any difference between our estimates and the government's estimates of the costs of reforms we do model.

Calculating the distributional impact of tax and benefit changes

To allocate changes in taxes and benefits across the income distribution, we divide the population of households into 10 equal-sized groups ('decile groups') according to their income, measured after taxes and benefits and adjusted for household size. In the analysis in this Briefing Note, we do this using a simulated 2005 population with net incomes calculated using the April 2005 tax and benefit system; if instead we were to use the uprated May 1997 tax and benefit system – putting households into decile groups according to what their net incomes would have been in the absence of Labour's reforms – then the results here would look even more progressive. Data limitations mean that the distributional effects are for households in Great Britain, but the aggregate revenue estimates in Table 1 are for the whole of the UK; for the distributional analysis, we scale down the aggregate revenue numbers to reflect the proportion of UK households that are in Great Britain, in effect assuming that the aggregate revenue effect of reforms in Northern Ireland is proportional to that in the rest of the UK.

⁶ Changes to stamp duty on residential properties are allocated in a different way; for a description, see section 7.3 of R. Chote, C. Emmerson, D. Miles and Z. Oldfield (eds), *The IFS Green Budget: January 2005*, IFS, London, 2005 (<http://www.ifs.org.uk/budgets/gb2005/05chap7.pdf>).