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Analysis of Scottish tax and benefit reforms

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5. Analysis of Scottish tax and benefit reforms

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In recent years, powers to change the tax and benefit system have been devolved to the Scottish Government. These powers have been used to make the system overall more progressive, with more generous benefits boosting the incomes of poorer households, and higher taxes reducing the incomes of richer households.

With regards to income tax, the Scottish Government has the ability to set income tax rates and bands on income other than from dividend or interest payments, with the exception of the personal allowance. It has used these powers to introduce a new system with more bands and different rates compared with that used in the rest of Great Britain (rGB, i.e. England and Wales),[1] with the consequence that lower earners pay a little less in tax, whilst higher earners pay quite a bit more. All income tax liabilities were increased by the measures announced in the Scottish Budget published in December 2022.

Changes to benefits include the introduction of several new benefits, including the Scottish child payment (which was increased to £25 per week from November 2022, and expanded to cover low-income families with children under 16), and the Best Start grants (providing support for low-income families with babies and young children). Other UK-wide benefits policies are adjusted, for example by topping up carer's allowance and undoing the effects of the benefits cap and under-occupancy charge ('bedroom tax'). Overall these changes will deliver a big increase to the incomes of, in particular, low-income families with children. A new system of disability benefits is also being brought in, which will see claims assessed and managed differently, though the rates will be the same.

In this chapter, we first analyse the impact of changes to devolved income tax rates and bands and benefits, taking effect between April 2022 and April 2023, on Scottish households' take-home incomes, both on average and across the income distribution. We then show the total impact of the changes to income tax and the benefits system since powers were devolved to

[1] The comparison system we focus on here is rGB, rather than the entirety of the rest of the UK, because there are some minor differences in benefit policy in Northern Ireland.

Scotland. Finally, we focus on disability benefits, which are set to become an area of increasing divergence between Scotland and rGB, and which have seen a recent sharp uptick in applicants across the UK.

Key findings

1. Scottish child payments were increased and extended to more families in November 2022. In addition, the Scottish Budget announced an increase in the top two rates of income tax, and freezes or reductions to income tax thresholds, from April 2023. The combined effect of these reforms is to reduce the average net income of Scottish households by £110 per year, or 0.3%.

2. The effects of these reforms differ significantly across the income distribution. Households towards the top of the distribution will be net losers as a result of the income tax changes, which will cost the richest tenth of Scottish households almost £1,400 per year on average (1.2% of their income). In contrast, poorer households have gained from the increase and big expansion of the Scottish child payment. The poorest tenth of Scottish households will gain the equivalent of almost £260 per year, or 2% of their incomes, on average, from the combined effect of the benefits and income tax changes. Households with children in approximately the bottom third of the income distribution will gain, on average, around £1,200 per year – around 4%–5% of their incomes.

3. These reforms continue a trend of the Scottish Government using its devolved income tax and benefit powers to increase the progressivity of the tax and benefit system. Taken together, reforms to Scotland's income tax rates and bands and devolved benefits will have reduced the average income of Scottish households by £210 (or 0.5%) per year by 2023–24, compared to what their incomes would be in England and Wales. However, the poorest tenth of households will, on average, have benefited to the tune of £580 (4.6%) per year as a result of higher benefit entitlements, whilst the richest tenth will be £2,590 (2.1%) worse off as a result of higher income tax payments.

4. There has been a sharp increase in the number of people successfully claiming disability benefits over the last 18 months, in both Scotland and the rest of Great Britain: the number of people starting disability benefits was 90% above its 2016–20 average in October 2022 in Scotland, and 96% higher in England and Wales. This does not appear to be due to eligibility tests becoming less stringent as there has been a similar increase in the number of people applying and being found ineligible.

5. The Scottish Government has begun to roll out a new devolved disability benefit, adult disability payment, to replace the UK's pre-existing personal independence payment. The expectation is that changes to the assessment and re-appraisal process will result in more people being found eligible for support. If this occurs, this will boost the incomes of a group that tend to have low living standards (half of the most materially deprived individuals living in Scotland report being disabled). However, especially in the context of an uptick in claims, this will put further pressure on Scotland's benefits budget.

5.1 Tax and benefit reforms since April 2022

This section looks at the effect of recent tax and benefit reforms by the Scottish Government on Scottish households' incomes. Specifically, the changes we model are:[2]

- freezing the basic, intermediate and higher rate income tax thresholds, at £14,733, £25,689 and £43,663, respectively;
- cutting the additional rate threshold to £125,140;
- increasing the higher and additional rates of income tax by 1p to 42% and 47%, respectively;
- increasing the Scottish child payment to £25 per week, and expanding eligibility from children aged up to 5 to those aged up to 16.

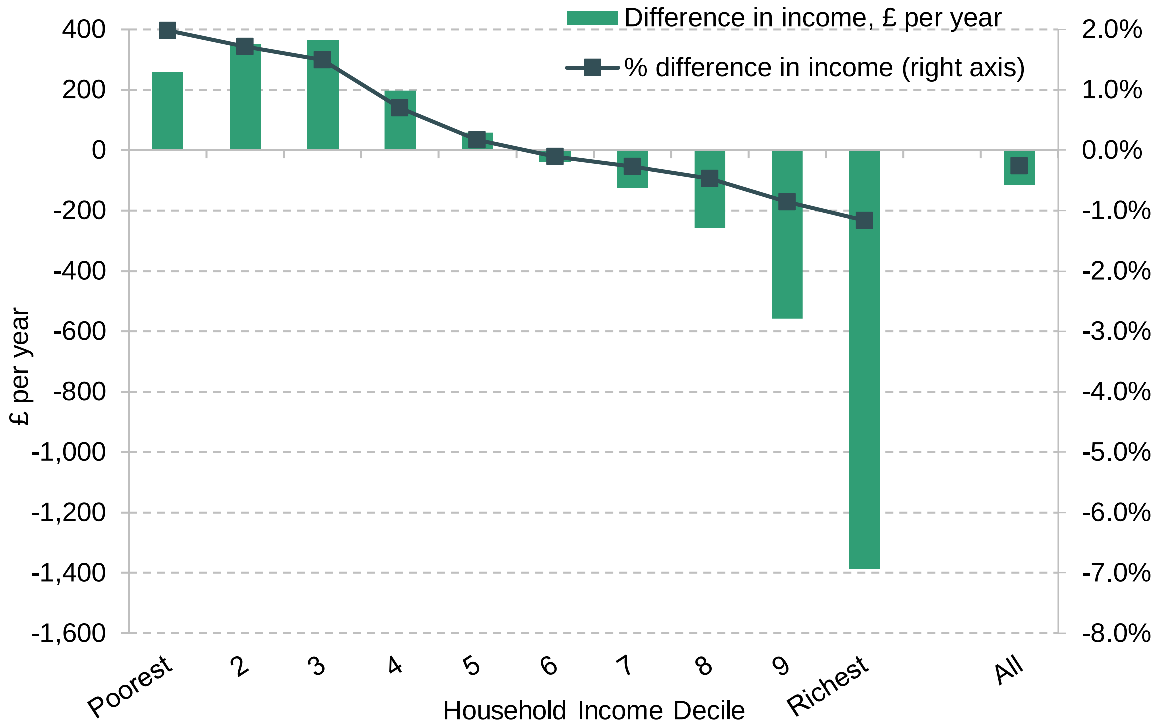
The combined impact of these measures is to reduce Scottish households' incomes by an average of £110 per year, or 0.3%, as shown in Figure 5.1. But the effects differ markedly across the income distribution: the reforms reduce the incomes of the richest 10% of households by 1.2% (almost £1,400), and increase the income of the poorest 10% by 2% (£260 per year).

The freeze to the higher rate threshold of income tax is driving most of the additional revenue for the Scottish Government (and therefore income losses for Scottish households). This will raise around £390 million (Scottish Government, 2022a). By comparison, the 1p increases in the higher and additional rates generate additional revenue of £95 million, whilst the additional rate threshold reduction will raise a further £8 million (Scottish Fiscal Commission, 2022b).[3]

[2] Scottish tax policies that are not modelled include changes to land and buildings transaction tax (LBTT) and business rates, which will not directly reduce household incomes but which will indirectly reduce them.

[3] These estimates account for behavioural responses. In the absence of behavioural changes, the policies would raise £160 million and £33 million, respectively.

Figure 5.1. Household disposable income under the April 2023 Scottish tax and benefit system, compared with April 2022



Note: Income changes shown are before any behavioural response from households. This is especially important for the increase in the additional rate of income tax, which the SFC expects to generate significant behavioural response (e.g. reducing income or migration out of Scotland).

Source: Authors' calculations using the Family Resources Survey (FRS) 2017–19 and TAXBEN, the IFS tax and benefit microsimulation model.

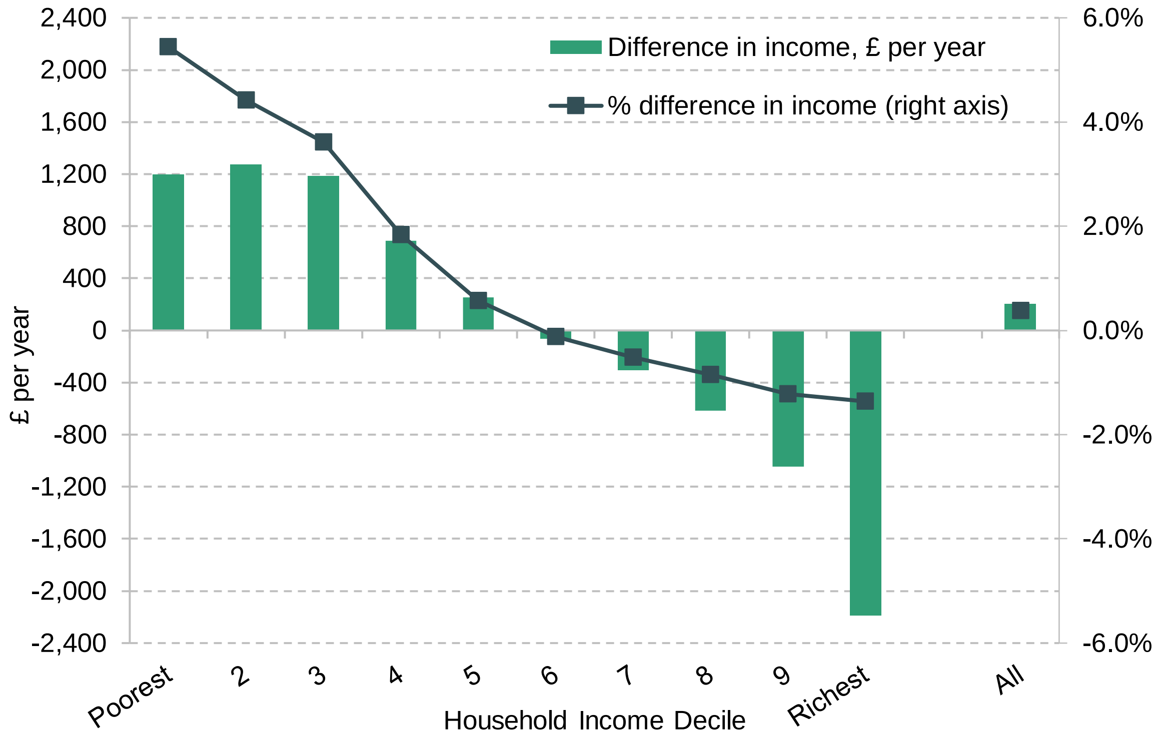
The freeze to the income tax personal allowance by the UK government is also significantly increasing the income tax paid by Scottish households, and will affect lower earners as well as higher earners. Scottish households will lose £330 per year on average as a result of this freeze, whilst over £800 million of revenue will be raised for the UK government.[5] Figure 5.1 does not include this impact, as our focus here is on the Scottish Government rather than UK government policy, and the Scottish Government does not control the personal allowance. The figure shows the impact of reforms that are the result of Scottish Government policy (whether or not this policy is the same as the UK government's) coming into effect in the period after April 2022 and up to and including April 2023.

[5] Strictly speaking, the freeze in the personal allowance will increase the income tax revenues raised in Scotland, but because it will also raise revenues by a similar proportionate amount in rGB, this will be offset by a larger adjustment to the Scottish Government's block grant funding to account for tax devolution (the 'block grant adjustment'). This broadly means that the revenues will flow to the UK government.

The big expansion of eligibility for the Scottish child payment in November 2022 is estimated to have quadrupled the number of eligible children to around 400,000 (Scottish Government, 2022). The increase in the payment amount from £20 to £25 a week is sufficient – on average – to offset the increase in tax for those in the bottom half of the income distribution. The payment is targeted at poorer families as eligibility is dependent upon receiving a means-tested benefit.

Naturally, the Scottish child payment reforms only affect households with children. Figure 5.2 highlights this point by repeating the exercise of Figure 5.1 but for households with children only. This shows even bigger increase among lower-income households: the poorest 30% see, on average, an increase in income of £1,200 a year. Indeed, following these reforms, the Scottish child payments will boost some households' incomes very substantially. For example, a non-working lone parent with two children aged 3 and 5 would see their income after housing costs increased by 19% as a result of the payments. In contrast, poorer households without children

Figure 5.2. Household disposable income under the April 2023 Scottish tax and benefit system, compared with April 2022: households with children



Note: Income changes shown are before any behavioural response from households. This is especially important for the increase in the additional rate of income tax, which the SFC expects to generate significant behavioural response (e.g. reducing income or migrating out of Scotland). Household income deciles are defined with respect to the whole population.

Source: Authors' calculations using the FRS 2017–19 and TAXBEN, the IFS tax and benefit microsimulation model.

see virtually no change in their incomes as a result of recent policy changes (see Figure A.1 in the Appendix) – they neither gain from the expansion of child payments nor lose much from Scottish Government income tax reforms (as their incomes are too low to be affected).

5.2 Comparison with England and Wales

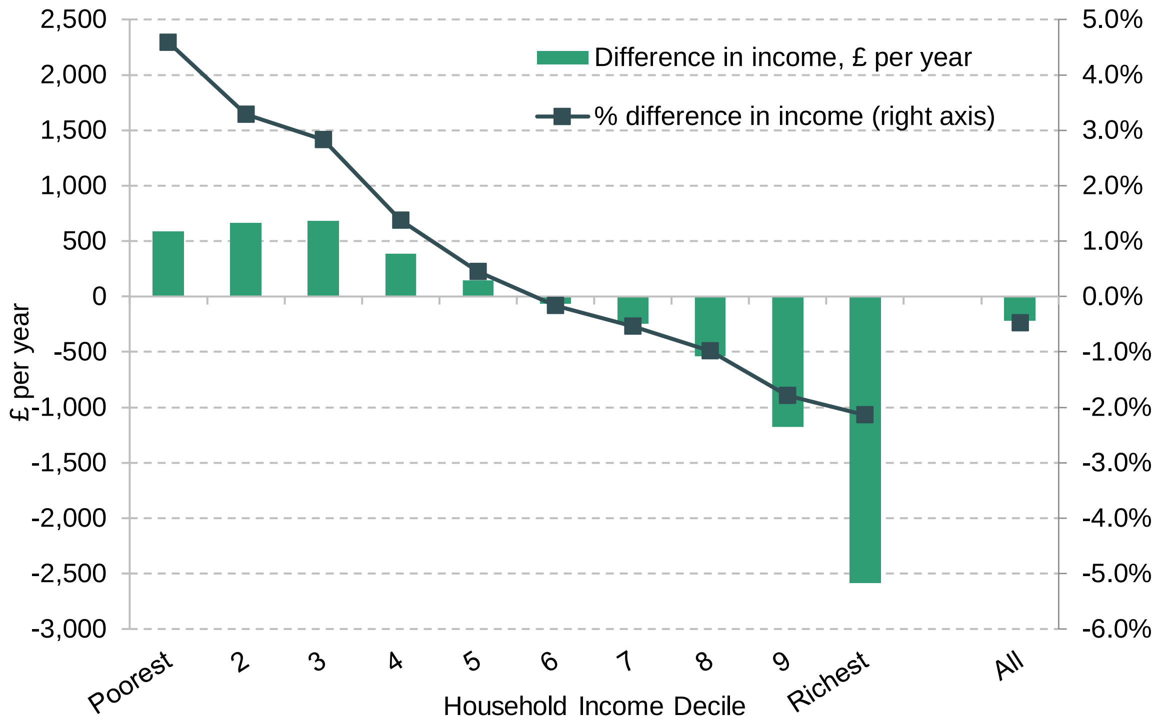
Whilst some of the changes announced in December's budget are in line with UK government policy – both governments have frozen the higher rate threshold and reduced the additional rate threshold – the other policies announced represent a further divergence between the tax and benefit system in Scotland and that in rGB. Figure 5.3 illustrates the total effect on Scottish households' incomes of the differences in income tax and benefits policy in Scotland compared with policy in rGB. The benefit changes include not only the Scottish child payment, but also Best Start payments (which support low-income families with babies and very young children), the supplement for the carer's allowance, and mitigation of the under-occupancy charge ('bedroom tax') and the benefit cap, which affects around 4,000 households (Department for Work and Pensions, 2022). The figure shows that, overall, average household incomes in 2023–24 will be slightly reduced by Scottish income tax and benefits policy measures: by £215 or 0.5%.

But again, there is significant variation across the household income distribution. Poorer households benefit from new benefits and top-ups, as well as slightly lower rates of income tax for low-earning taxpayers. The poorest 10% will be £580 per year better off as a result of the Scottish policies we model, or 4.6% of what their incomes would be under UK government policy. Overall, the Scottish Fiscal Commission (SFC) estimates the cost of these policies to be £596 million (Scottish Fiscal Commission, 2022b).

Again, it is almost entirely benefits for families with children that explain the additional income for the poorest households. This is illustrated by Figures A.2 and A.3 in the Appendix, which show the differences for households with and without children, respectively. Amongst the poorest 30% of households, those with children will see their incomes boosted by around a sizeable £2,000 a year on average, driven by higher benefits for families with children.

In contrast to poorer households, the fact that earnings above £28,000 are taxed more heavily in Scotland means that those further up the income distribution generally have lower incomes as a result of Scottish policy. For example, someone on £50,000 will pay £1,550 more tax in Scotland than rGB, and someone on £150,000 will pay £3,900 more, in the coming tax year. The richest tenth will be £2,590 per year worse off under the Scottish income tax and benefit system (2.1%) on average in 2023–24. In total, the SFC estimates that, before accounting for behavioural response, Scottish income tax policy will raise £1 billion in the coming financial year (Scottish Fiscal Commission, 2022b).

Figure 5.3. Household disposable income under the Scottish tax and benefit system, compared with the system in England and Wales, April 2023



Note: Scottish policies modelled include the Scottish income tax system, Scottish child payment and Best Start payments, the carer's allowance supplement, and mitigation of the under-occupancy charge and benefit cap. Differences between the Scottish and rGB council tax systems are not modelled. Income changes shown are before any behavioural response from households. This is especially important for the increase in the additional rate of income tax, which the SFC expects to generate significant behavioural response (e.g. reducing income or migrating out of Scotland).

Source: Authors' calculations using the FRS 2017–19 and TAXBEN, the IFS tax and benefit microsimulation model.

5.3 Disability benefit claims and reforms

Working-age adults with disabilities are supported by two types of payment. Incapacity benefits (either employment and support allowance or an additional element in universal credit) are paid to those who are deemed unable to work because of their condition. Disability benefits – our focus here – aim to support those who have higher living costs due to their disability, and eligibility is not contingent on being unable to undertake paid work and the payments are not means-tested. The main disability payment in the rGB (and Northern Ireland) is the personal independence payment (PIP). Entitlements range from £1,271 to £8,159 per year depending on the severity of the condition. 8.4% of working-age adults in Scotland receive PIP (or its predecessor, disability living allowance).

Scotland has recently begun replacing PIP with the adult disability payment (ADP). ADP has the same rates as PIP, but the assessment process will differ. There will be fewer face-to-face assessments and, perhaps because of this, the ADP form that applicants must fill out is more detailed than the PIP form. Reassessments that do take place will be carried out by Social Security Scotland rather than private contractors. Whereas most PIP awards have a specified length, at the end of which claimants must reapply for PIP or see their payments end, ADP awards are all indefinite – though, like PIP, usually ADP claimants do still have to go for occasional reassessments to check that they are still eligible. The Scottish Government has promised to tailor the time to these reassessments more to individual circumstances. Those who are deemed to be unlikely to see significant changes in their condition will be reassessed no more than once every five years.[6] The Scottish Government is also replacing the disability benefit for children, though here we focus on the adult payments.

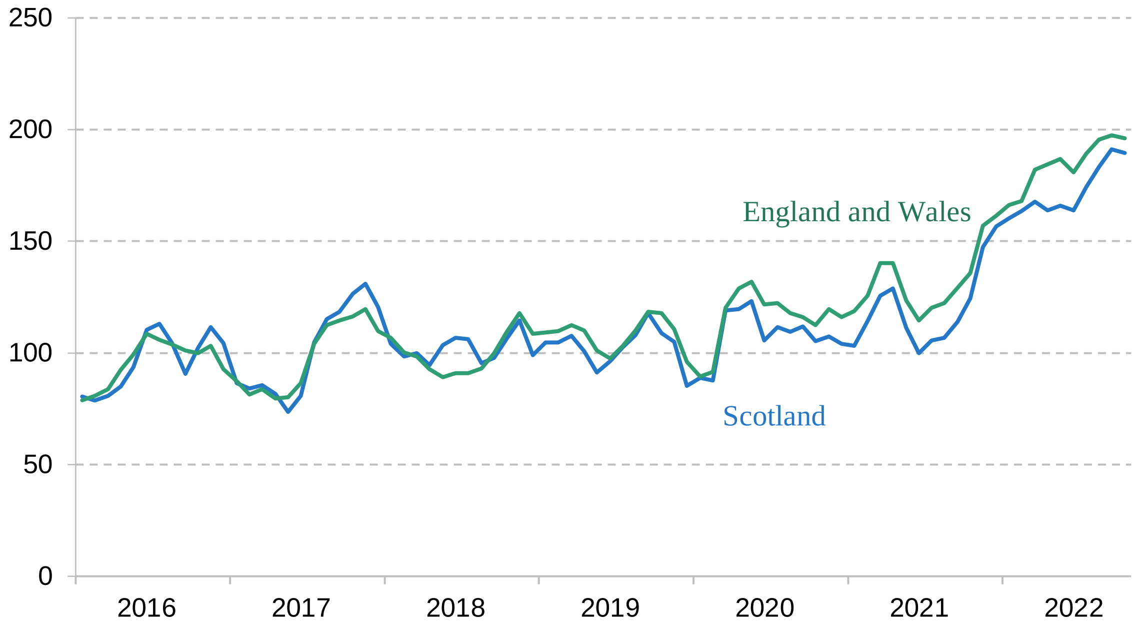
Importantly, these changes are forecast to lead to more people successfully claiming, and spending longer on the benefit. As a result, the SFC expects that, by 2027–28, ADP will cost £650 million per year more than PIP (Scottish Fiscal Commission, 2022b), a 19% increase and equivalent to £260 per year per Scottish household.

A key piece of background here is that across Great Britain we have recently seen a sharp rise in the number of people being awarded disability benefits. Figure 5.4 shows an index of the number of new PIP or ADP awards in Scotland, and in England and Wales. In the several years up to the pandemic, there was little change in monthly claims. 2020 and the first half of 2021 saw a noticeable rise, especially in England and Wales, but this was then eclipsed by a much bigger increase (for England and Wales, and Scotland alike) from the middle of 2021 to the end of 2022. In the latest few months of data (up to October 2022), the number of people flowing on to disability benefits each month was a little under double its pre-pandemic average (90% higher in Scotland and 96% higher in England and Wales). Because this sharp rise almost entirely pre-dates ADP (which only began to be rolled out in a small way in March 2022), and because it is mirrored in England and Wales, ADP is not the driving factor.

Precisely what is behind this increase is unclear (see Joyce, Ray-Chaudhuri and Waters, 2022). It does not appear to be that the system has become more lenient, as the number of applications has seen a similarly meteoric rise, leaving the share of applicants who are successful broadly unchanged. If this is a permanent change in trajectory, it implies significantly more disability spending going forward – and indeed both the SFC and the UK's Office for Budget Responsibility have significantly upped their forecast for disability benefit expenditure accordingly.

6 See Adam and Phillips (2021) for a more detailed discussion of this reform.

Figure 5.4. Monthly new PIP or ADP awards (three-month rolling average; index, January 2016 to February 2020 = 100)



Note: Up to October 2022. Includes new awards from mandatory reassessments or appeals. Does not include Disability Living Allowance reassessments.

Source: Authors' calculations using Stat-Xplore, Department for Work and Pensions.

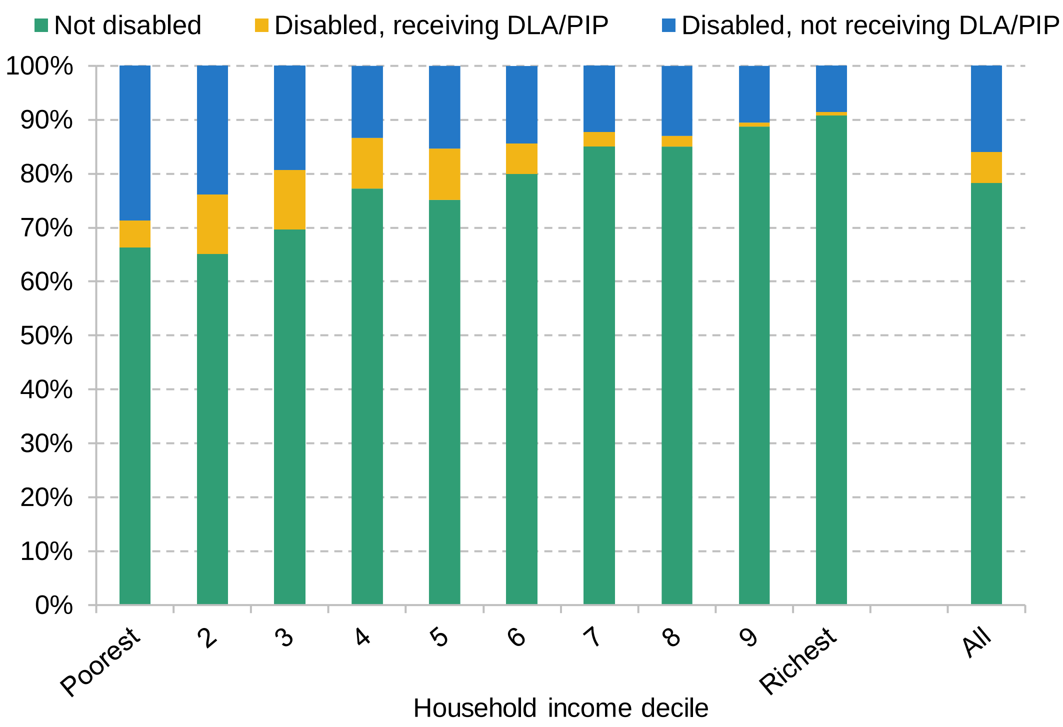
The implications for the Scottish Budget are complicated by the operation of the Fiscal Framework. Each year, this updates the amount provided to the Scottish Government to pay for devolved benefits (the block grant adjustment) by the increase in spending on equivalent benefits in England and Wales. If spending per person increases more quickly in percentage terms in Scotland, money from elsewhere in the Scottish Government's Budget needs to be found to top up this funding; conversely, if spending per person increases less quickly in percentage terms in Scotland, some of the money provided for devolved benefit spending can be used for other things instead.

As discussed above, the Scottish Government is changing the assessment and re-appraisal processes for its disability benefits in ways that are expected to increase the fraction of people deemed eligible for support, and to increase the length of time they receive support. If more people are applying for support, then the cost of this more lenient system is likely to be greater. Unless offset by some other factor, this would further push up the rate of growth of disability benefit spending in Scotland relative to England and Wales, putting the Scottish Government's benefits budget under further pressure. The SFC revised up its forecasts of the cost of ADP relative to the forecasts for the block grant adjustment funding the Scottish Government will receive in its December forecast. But there is significant uncertainty about just how much more these costs will be, given the uncertainty about both how the number of people applying for disability benefits will evolve, and how the fraction deemed eligible (and the average time they are deemed eligible for) will change in Scotland compared with England and Wales.

But given that it looks like more people are going to end up on disability benefits in Scotland – both because of the rise in applications, and because ADP is expected to lead to more of these applications being successful – it is worth briefly reviewing who receives these benefits. Figure 5.5 shows where disabled people in Scotland are in the household income distribution (where disability is defined as having a long-term health condition that affects their ability to carry out day-to-day activities). We split those who are disabled into those who do and do not receive a disability benefit.

The figure shows that disabled people are more likely to be located in the bottom half of the income distribution. This is particularly true for those on disability benefits, although those who are disabled but *not* in receipt of disability benefits are more likely to be at the very bottom of the income distribution.

Figure 5.5. Disability status, by household disposable income decile, 2017–18 to 2019–20

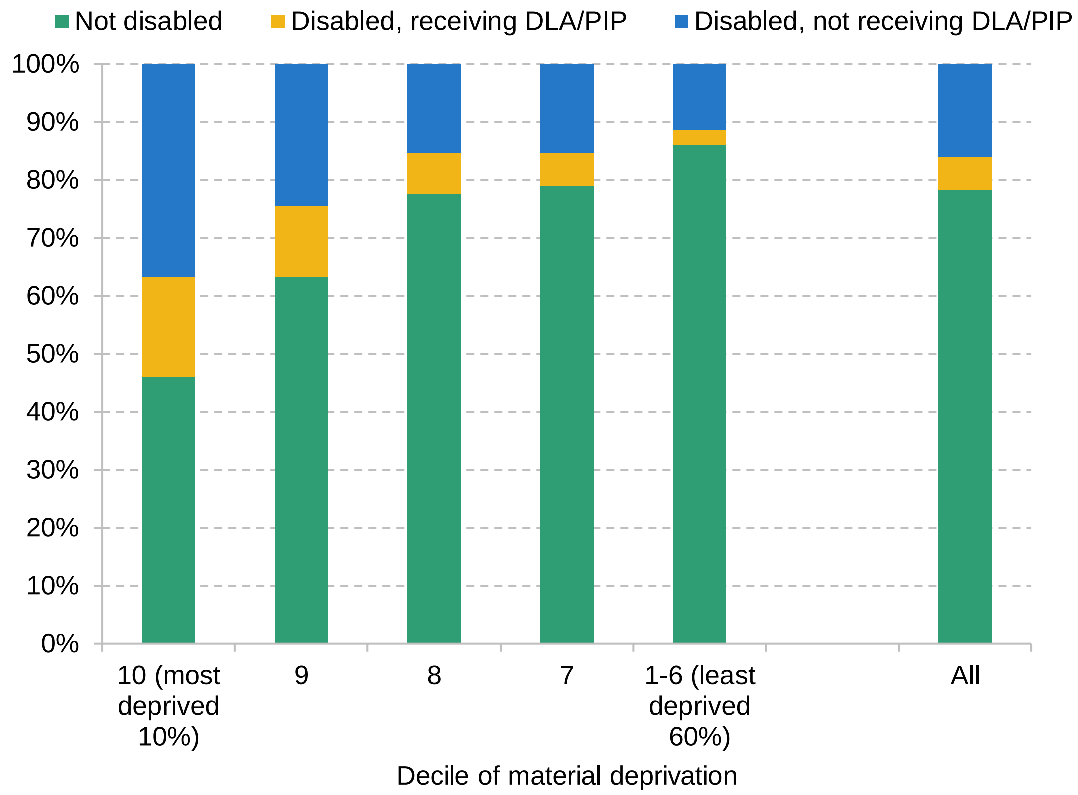


Note: The sample is adults in Scotland below state pension age. We use reported receipt of DLA/PIP in the survey. Because some people receive DLA/PIP but do not report it in the survey, the fraction labelled as receiving DLA/PIP is slightly lower than the actual share of adults who receive it.

Source: Authors' calculations using the FRS 2017–19.

However, even this is likely to overstate the living standards of those in receipt of disability benefits. Many disabled people face higher living costs because of their disability – and in fact this is the key justification for PIP and ADP in the first place[7] – but this is not captured when we simply compare differences in household income. Put simply, receipt of a disability benefit will push a household up the income distribution whereas the rationale for the payment is to compensate for costs that non-disabled households do not face. An alternative way to measure living standards that avoids this problem is to examine the material deprivation faced by different households. Material deprivation scores are based on whether a household reports being unable to afford some basic items, such as the ability to keep the house warm, to replace worn out furniture, and to go on holiday once a year. Figure 5.6 shows where disabled individuals are located in the material deprivation distribution. Here we see even more clearly

Figure 5.6. Disability status, by decile of material deprivation, 2017–18 to 2019–20



Note: The sample is adults in Scotland below state pension age. We use reported receipt of DLA/PIP in the survey. Because some people receive DLA/PIP but do not report it in the survey, the fraction labelled as receiving DLA/PIP is slightly lower than the actual share of adults who receive it.

Source: Authors' calculations using the FRS 2017–19.

[7] These benefits are designed to reflect the extra costs associated with being disabled rather than to make up for lost income (which is the role of universal credit and its predecessor benefits).

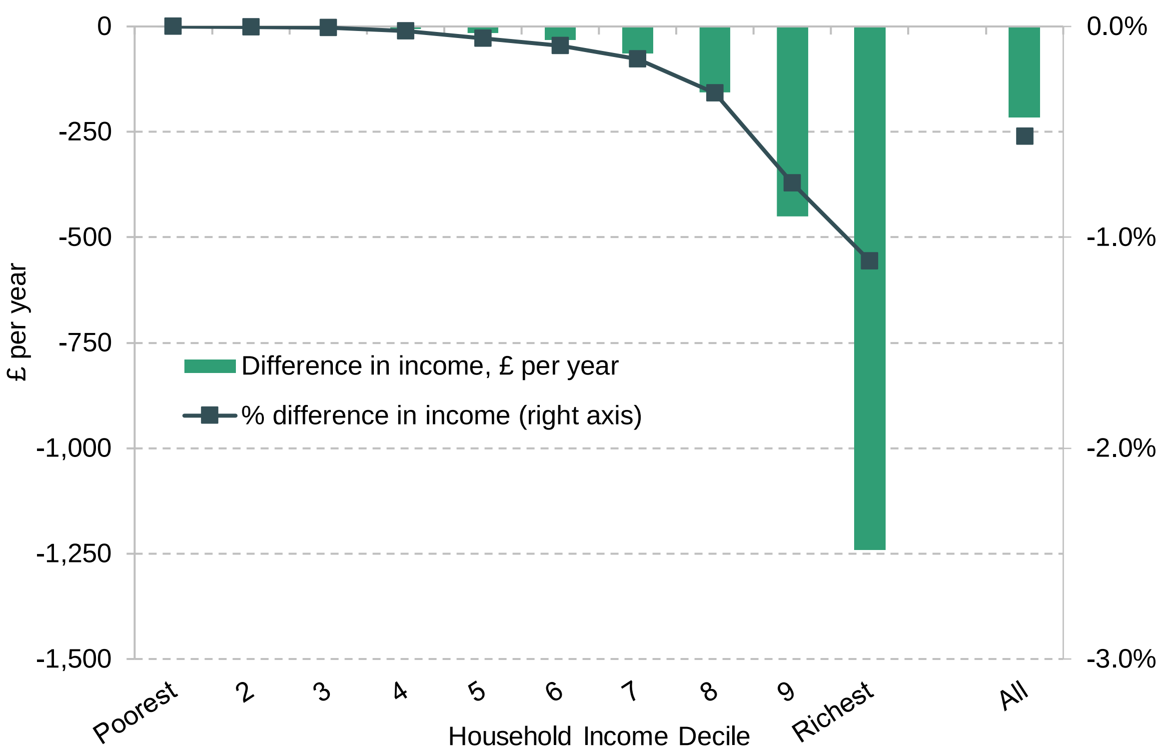
that disabled people are likely to have lower living standards than the wider population. More than half of the most deprived tenth of the population are disabled, though even most of this group do not receive disability benefits.

Together, this suggests that an increased leniency in disability benefits (if that is indeed what ADP ends up delivering) will be broadly targeted at households with low living standards. This means that the gap in progressivity between Scotland, and England and Wales is likely to eventually be even larger than we show in Figure 5.3, which does not incorporate the ADP reforms (which are only just rolling out).

However, the reduced stringency of Scotland's disability benefits is coming at the same time as what seems to be a worsening in the health of the Scottish and wider UK population. Together, these factors are likely to put significant increased upward pressure on Scotland's disability benefit spending.

Appendix

Figure A.1. Household disposable income under the April 2023 Scottish tax and benefit system, compared with April 2022: households without children



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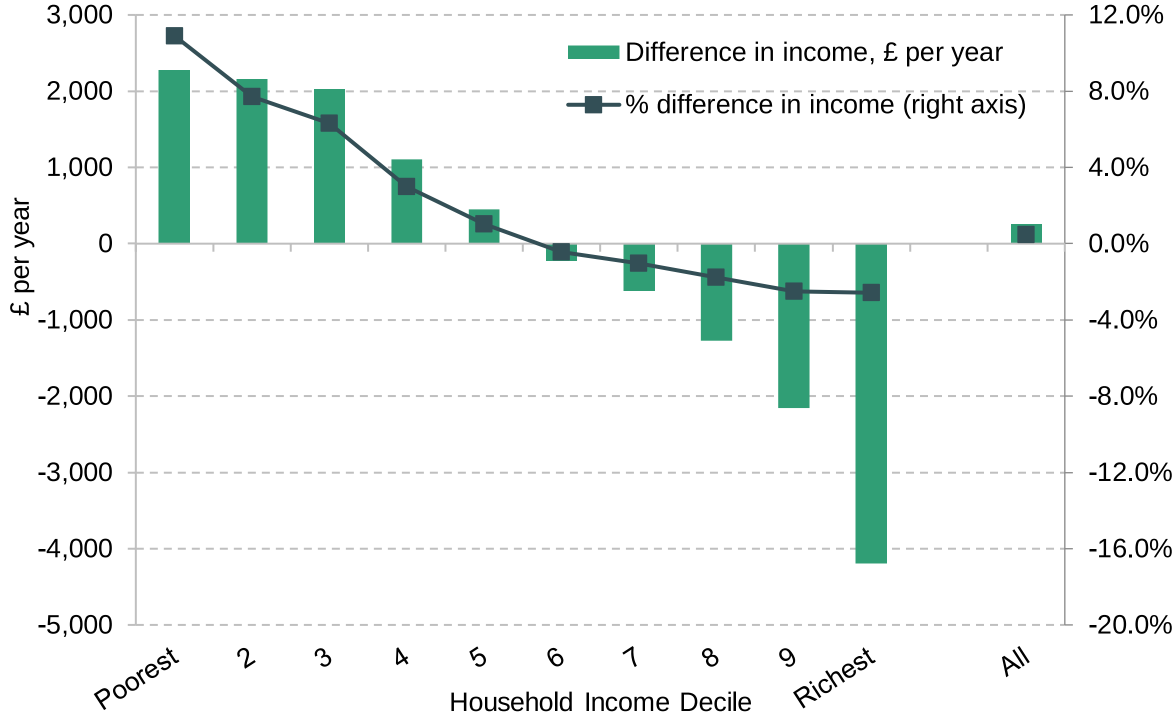
Source: Authors' calculations using the FRS 2017–19 and TAXBEN, the IFS tax and benefit microsimulation model.

Figure A.2. Household disposable income under the Scottish tax and benefit system, compared with the system in England and Wales, April 2023: households with children



Note: Scottish policies modelled include the Scottish income tax system, Scottish child payment and Best Start payments, the carer's allowance supplement, and mitigation of the under-occupancy charge and benefit cap. Differences between the Scottish and rGB council tax systems are not modelled. Income changes shown are before any behavioural response from households. This is especially important for the increase in the additional rate of income tax, which the SFC expects to generate significant behavioural response (e.g. reducing income or migrating out of Scotland).

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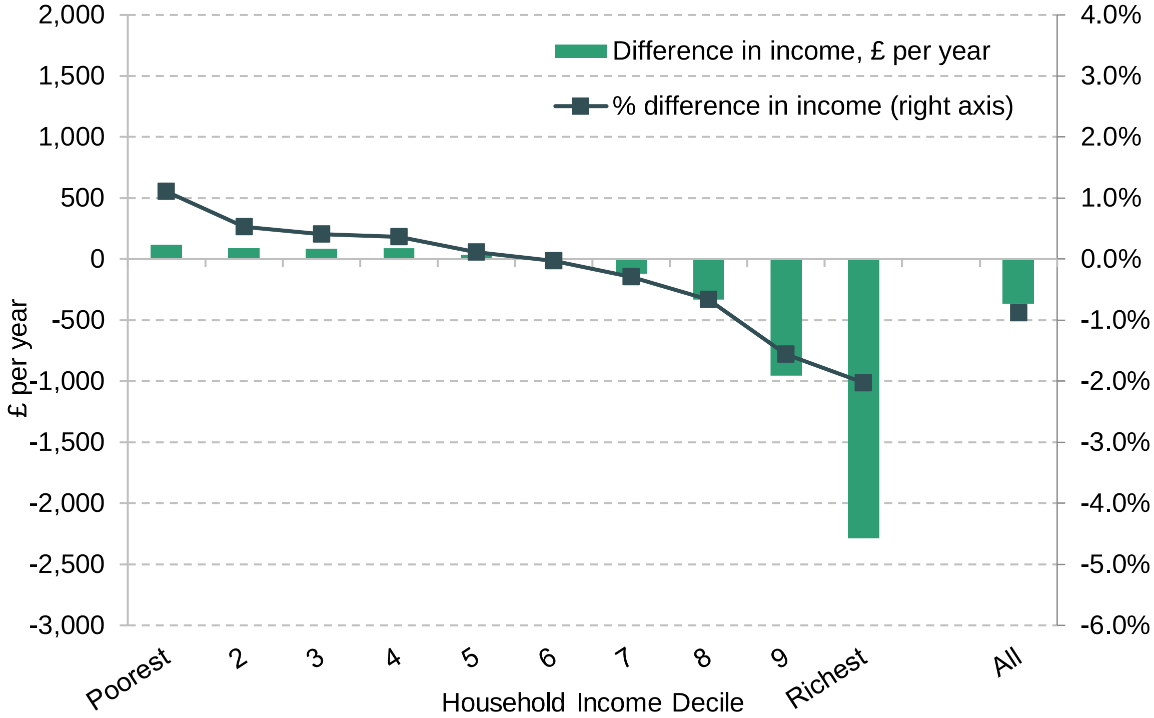
Figure A.3. Household disposable income under the Scottish tax and benefit system, compared with the system in England and Wales, April 2023: households without children



Note: Scottish policies modelled include the Scottish income tax system, Scottish child payment and Best Start payments, the carer's allowance supplement, and mitigation of the under-occupancy charge and benefit cap. Differences between the Scottish and rGB council tax systems are not modelled. Income changes shown are before any behavioural response from households. This is especially important for the increase in the additional rate of income tax, which the SFC expects to generate significant behavioural response (e.g. reducing income or migrating out of Scotland).

Source: Authors' calculations using the FRS 2017–19 and TAXBEN, the IFS tax and benefit microsimulation model.

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