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Summary

The aims of our Report

In this Report, we examine the impact of the abolition of the 10 pence rate of income tax, considering separately the effects of initial implementation and the effects in the light of the changes to personal allowances announced on 13 May 2008. We consider future policy options relating to the personal tax system and the wider tax and benefits system of which it forms a part.

Low-income households and the abolition of the starting rate

We have received and summarised very detailed information on the size and composition of the group of people who stood to lose from the removal of the starting rate of income tax as initially implemented. The losers from the measures as initially implemented were people whose taxable income was small, and for whom the loss might be significant when required to manage a personal or household budget at a time of sharply rising prices for many essential goods and services.

Options for 2008–09 and the changes announced on 13 May 2008

The problem arising from the removal of the starting rate of income tax was based within the tax system, and required a tax solution. For the current tax year, in the circumstances which the Chancellor of the Exchequer faced, the option chosen on 13 May of increasing personal allowances, but confining the benefits to basic rate taxpayers, was probably the least bad option, with the benefits of simplicity, transparency and greater incentives to work on the basis that fewer taxpayers face high marginal deduction rates. However, £2 billion of the £2.7 billion committed to that measure in the current financial year is not devoted to compensating losers from the removal of the starting rate of income tax, and as such was not substantially well-targeted.

The broader context

If the Government wishes to meet its fiscal rules, it will have to take them fully into account when proposing further changes to the personal taxation and welfare systems. The case for action to meet the Government's target to halve child poverty by 2010–11 is more pressing than ever given the further rise in child poverty by 100,000 children in 2006–07 to 2.9 million before housing costs. Pensioner poverty rose significantly in 2006–07, by 300,000 to 2.6 million before housing costs, reversing the welcome downward trend since 1997, and progress on fuel poverty is threatened by rising fuel prices. The advances made in tackling poverty among those out of work in the last decade has not been matched by comparable progress in tackling poverty among those in work.

Getting the process right

The Government must learn lessons relating to budgetary processes. We recommend that the Government publish a Household Impact Assessment alongside future Budgets and Pre-Budget Reports. This would analyse the impact on individual, family and household finances of Budget measures and other changes to the welfare system. We welcome the emphasis by the Government on the 2008 Pre-Budget Report, but the Government should not simply respond to a short-term political problem by turning the 2008 Pre-Budget Report into an early Budget. Instead, the Government must re-establish the consultative nature of the Pre-Budget Report. For personal tax decisions, the sudden and final nature of Budget decisions has been less about the need to prevent forestalling activity than it has been about the perceived benefit of seeming to pull rabbits from the hat. Recent experiences suggest that such short-term benefits are outweighed by the longer term benefits resulting from proper consultation.

The way forward

No reforms other than those to the tax system are likely to be effective if viewed principally as mechanisms for compensating the remaining 1.1 million households who lose from the removal of the starting rate of income tax even after the 13 May changes. There is a pressing need for the Government to seriously examine ways in which these remaining households can be compensated. For future years, the Government must ensure that the original 5.3 million losing households do not suffer losses from the abolition of the starting rate. The Government should set out proposals to achieve this by the time of the 2008 Pre-Budget Report. The announcement on the 13 May of the raising of personal allowances was a welcome step towards a simpler tax system with fewer low paid people paying income tax; further complications should now be resisted. Although the fiscal circumstances remain challenging, every effort should be made to avoid returning low-paid people into the income tax system.

In the longer-term, reforms should be centred on the greater challenges faced by the Government in combating poverty. We recommend the establishment of a Poverty Commission on a similar basis to the Pensions Commission to examine the public policy challenges relating to poverty.

1 Introduction

1. "Having put in place more focused ways of incentivising work and directly supporting children and pensioners at a cost of £3 billion a year, I can now return income tax to just two rates by removing the 10p band on non-savings income."[1] With these words, in the 2007 Budget statement on 21 March 2007, the Rt. Hon. Gordon Brown MP, the then Chancellor of the Exchequer, announced that the 10 pence rate of income tax would be removed with effect from April 2008. That decision, and the reduction of the basic rate of income tax to 20 pence, also with effect from April 2008, which was announced in the same Budget, initially attracted only limited debate and controversy. However, since late March this year, the abolition of the 10 pence rate and its consequences have become central to political and public debate.

2. In this Report, we seek to contribute to that debate by—

- setting out the background to the abolition of the 10 pence rate of income tax;
- analysing the effects of the abolition of the 10 pence rate of income tax as initially implemented on individuals and households, particularly considering the impact on low-income households;
- exploring policy options for implementation in 2008–09, including the changes to personal allowances announced by the Government on 13 May 2008;
- analysing the broader context in which decisions relating to future years will need to be taken;
- identifying improvements to budgetary processes to prevent a repetition of the recent difficulties; and
- exploring policy options for future years and making recommendations.

3. We announced our inquiry on 22 April, indicating that we expected to complete our inquiry and report in advance of the report stage of the Finance Bill in the House of Commons.[2] On 30 April, we set out the terms of reference for our inquiry and invited written evidence.[3] On 15 May, we invited additional written evidence arising from the Government's policy announcement on 13 May relating to personal allowances for 2008–09.[4] On 21 May, we took oral evidence from the Institute for Fiscal Studies (IFS), Citizens Advice, the Low Incomes Tax Reform Group (LITRG) of the Chartered Institute for

1 HC Deb, 21 March 2007, col 826

2 Treasury Committee Announcement, "Treasury Committee announces new inquiry: Budget Measures and Low-Income Households", 22 April 2008. All announcements referred to are available on the Committee's website at the following address: http://www.parliament.uk/parliamentary_committees/treasury_committee/treasury_committee_press_notices.cfm.

3 Treasury Committee Announcement, "Treasury Committee invites written evidence for inquiry into Budget Measures and Low-Income Households", 30 April 2008

4 Treasury Committee Announcement, "Forthcoming evidence sessions, publication of written evidence and call for additional written evidence", 15 May 2008

Taxation, the Social Market Foundation (SMF), the Institute for Public Policy Research (IPPR), the Child Poverty Action Group (CPAG), Age Concern England (the National Council on Ageing), the Trades Union Congress (TUC) and the New Policy Institute (NPI). On 4 June, we took oral evidence from the Rt. Hon. Alistair Darling MP, Chancellor of the Exchequer.

4. We received a great deal of valuable written evidence, including letters highlighting individual concerns about the effects of the abolition of the 10 pence rate of income tax. Some of this evidence is published with this Report, and the remainder has been made available for public inspection.[5] In preparing this Report, we have also taken account of the statistics published by the Department for Work and Pensions on 10 June 2008 relating to Households Below Average Income, although we have not had an opportunity to take evidence on those statistics. We are most grateful to all those who gave evidence in the course of the inquiry, and in particular to the IFS for its provision of invaluable quantitative evidence and associated analysis which greatly assists us and others interested in the development of public policy in this area.

5 For a list of published memoranda, see p 119; for a list of unpublished memoranda reported to the House and details of how they may be inspected, see p 120.

2 The policy context

The purpose of this chapter

5. As is implied in the title of our inquiry and of this Report, we believe that it is necessary to consider the abolition of the 10 pence rate of income tax in the context of other Budget measures concerned with low-income households. In this chapter we outline relevant measures announced in Budgets since the introduction of the starting rate of income tax in 1999, including the creation of the new tax credits system. We also refer to the impact of some of the measures prior to those announced in the 2007 Budget on marginal deduction rates. We consider the broader context, including the fiscal context and the Government's broader social policy objectives, in chapter 5.

Introduction of the 10 pence rate of income tax

6. The Labour Party's 1997 General Election manifesto stated:

> Our long-term objective is a lower starting rate of income tax of 10 pence in the pound. Reducing the high marginal rates at the bottom end of the earning scale—often 70 or 80%—is not only fair but desirable to encourage employment.[6]

In his 1998 Budget, the then Chancellor of the Exchequer confirmed his intention to bring in such a starting rate "when it is right for the economy".[7] The introduction of the measure was announced in the following year's Budget as follows:

> We said in our manifesto that we would introduce a 10p starting rate of income tax for individuals when it was prudent to do so. I repeated in the last Budget that we would introduce the 10p starting rate when it was prudent to do so. However, I have to tell the House that the 10p rate will not start in April 2000, like other income tax changes we are making today. It is prudent instead for people to get the benefit of the 10p starting rate now. So it will take effect in April 1999, a 10p starting rate on the first £1,500 of income, the lowest starting rate of tax since 1962, and it will be delivered a few weeks from today. People will see it in their pay packets in May. Nearly 2 million people will see their income tax bills cut in half, and take home 90p of every pound they earn.[8]

The accompanying Budget document expanded on the reasons for the new measure:

> To put work first in the tax and benefit system, the Government will introduce a 10p rate of income tax. From 6 April this year, taxpayers will pay only 10 pence in the pound on their first £1,500 of taxable income …When the 10p rate is introduced, there will be three main rates of income tax—10, 23 and 40%. Basic and top rate taxpayers will gain £1·15 a week from the change. But those on the lowest incomes

6 Labour Party, *New Labour: because Britain deserves better*, April 1997, pp 12–13

7 HC Deb, 17 March 1998, col 1104

8 HC Deb, 9 March 1999, col 188

> (below £8,835) will gain more, because the three rate structure helps to target the gains from the 10p rate on the lowest paid: 1.8 million people, of whom 1.5 million are low paid, will see their tax bill halved, and a further 300,000 people will be taken out of income tax altogether. The new 10p band will help to ease the poverty trap whereby people on low pay are discouraged from climbing the earnings ladder.[9]

7. The 10 pence tax rate was not without its critics. In January 1998, the IFS concluded:

> In terms of the key goal of improving work incentives, it is clear that the introduction of a 10% tax rate is an expensive way of achieving little. It is also clear that an income tax system with a 10% band is likely to increase the complexity of the tax system.[10]

Mr Edward Troup, then Head of Tax Strategy at Simmons & Simmons Solicitors, suggested to the then Treasury Committee following the 1999 Budget that "a perfectly simple tax system delivering whatever tax you want to almost anybody can be delivered with personal allowances and two rates of tax".[11]

The new tax credits system

The Taylor report

8. The introduction of the 10 pence rate of income tax formed part of a wider Government commitment to reform of the tax and benefits system as a whole, a process initiated in the 1998 Budget.[12] At the time of that Budget, the Government published a report on work incentives by Martin Taylor, then Chief Executive of Barclays Bank. That report referred to the two consequences of the tax and benefits systems as they then operated:

- "the unemployment trap", whereby "in-work support is not sufficient to make work worthwhile"; and
- "the poverty trap", whereby "the high rate of withdrawal of benefits as incomes rise deters the low paid from seeking to increase their earnings".[13]

The Taylor report rejected the case for "full-blown integration" of the tax and benefits systems because of the different objectives of the two systems (the funding of Government expenditure and the relief of need), because of differences in the mechanisms of distribution and collection and because, "while taxation is paid by individuals, benefit is paid to household groups; both these arrangements are fiercely defended".[14] The Taylor report recommended that the existing Family Credit be replaced by a tax credit which

9 HM Treasury, *Budget 99: Building a Stronger Economic Future for Britain*, HC (1998–99) 298, March 1999, p 60, paras 4.49–4.51

10 IFS, *Green Budget*, January 1998, pp 21–23, cited in Treasury Committee, Fourth Report of Session 1998–99, *The 1999 Budget*, HC 325, para 47, note 87.

11 HC (1998–99) 325, para 45

12 HC Deb, 17 March 1998, col 1097

13 HM Treasury, *The Modernisation of Britain's Tax and Benefit System: Number Two: Work Incentives: A Report by Martin Taylor*, March 1998, p 19, para 3.04

14 *Ibid.*, p 6, paras 1.10–1.11

would "associate the payment in the recipient's mind with the fact of working" and would be likely "to prove more acceptable to society at large".[15]

Working Families Tax Credit and Children's Tax Credit

9. The Taylor report was followed by the introduction in October 1999 of Working Families' Tax Credit (WFTC) and the Disabled Person's Tax Credit which replaced the Family Credit and the Disability Working Allowance. The WFTC was based on a 'snapshot' of income and circumstances at the time of the claim and was unaffected by changes of circumstances in the following six months, but was more generous than the Family Credit, included a childcare element and was paid through the pay packet rather than to the main carer. In April 2000, the Government also introduced a Children's Tax Credit which replaced the married couple's allowance and related allowances.[16]

Child Tax Credit and Working Tax Credit

10. In the 2000 Budget the Government announced its intention to "go further in improving the transparency and administration of income-related payments through the tax and benefit system".[17] The main principles underpinning the new approach were to separate support for children from that for adults, to extend support to low-income households with at least one working adult but no dependent children and to align assessments of eligibility more closely with the rules for income tax. These principles were reflected in the introduction in April 2003 of the Child Tax Credit and the Working Tax Credit. The former was to be paid to the main carer, usually the mother, and was to provide a common framework for both low- and middle-income families.[18] The Child Tax Credit was to be for families who were responsible for at least one child or qualifying person. The Credit was to consist of a number of elements designed to acknowledge the circumstances of different families:

- A family element, a basic element payable to families responsible for one or more children. A higher rate of family element, often known as the baby element, was to be paid to families with one or more children under one year old;
- A child element, payable for each child within the family; and
- A disabled child element, for families caring for a child with a disability or severe disability.[19]

The Working Tax Credit was to support low-income families with at least one working adult, including families without dependent children where one adult was working over 30 hours a week and aged 25 or over. For those with dependent children, Working Tax Credit

15 HM Treasury, *The Modernisation of Britain's Tax and Benefit System: Number Two: Work Incentives: A Report by Martin Taylor*, March 1998., p 8, para 1.22

16 Treasury Committee, Sixth Report of Session 2005–06, *The administration of tax credits*, HC 811–I, Annex, paras 6–7

17 HM Treasury, *Budget 2000*, p 87, para 5.16

18 HC(2005-06) 811–I, Annex, paras 8–9

19 HM Treasury and HMRC, Tax Credits: improving delivery and choice – a discussion paper, May 2008, p 11

was to include a childcare element to provide help with childcare costs for people spending money on registered or approved childcare. Eligibility for both of the new tax credits was to be assessed using a “modern income test”, building on the definition used in the tax system which was to be much more responsive to changing circumstances.[20]

11. The new tax credits system is significantly more generous than Family Credit. It benefits vastly more people, around 20 million adults compared with 2.8 million for Family Credit.[21] Take-up levels for the new tax credits among families with children have been high since their introduction and generally on an upward path. According to the Treasury, in 2005–06 take-up of the Child Tax Credit was 82% with over 90% of the money available being claimed. Take-up amongst those on low incomes in that year was 90% and reached 96% for those on incomes below £10,000.[22] Prior to its implementation, it was estimated that the new tax credits system would cost £2.7 billion more in 2003–04 than the previous system.[23] The IFS has estimated that the cost of administering tax credits in 2003–04 and 2004–05 stood at just over 3 pence per pound paid out, which was higher than the cost of administering the previous Working Families Tax Credit and nearly three times the cost of administering child benefit.[24]

12. When it reviewed the impact of its own reforms on incentives to work in March 2005, the Government emphasised the importance both of changes to the tax system and of tax credits. The Government identified the introduction of the 10 pence rate of income tax as one of the reforms of income tax and national insurance that had reduced the burden of tax on low-paid workers.[25] The Government also stressed the novelty of the Working Tax Credit, in that it was the first net tax payment from Government that benefited low-income working people without dependent children or a disability.[26] In part because of this novelty, the take-up of Working Tax Credit has been low amongst families without dependent children. In 2004–05, take-up among such families was around 19% by caseload and 25% by value. The Government estimated that around 980,000 families without dependent children had not claimed Working Tax Credit to which they were entitled, and the value of such unclaimed Working Tax Credits was £1.29 billion.[27] During our inquiry into the 2007 Budget, the then Chancellor of the Exchequer pointed to evidence of an upward trend in take-up among such families and reaffirmed the Government’s commitment to increasing take-up.[28] In its written evidence for the current inquiry, the Treasury drew attention to evidence of increased take-up of Working Tax Credit among

20 HC (2005–06) 811–I, Annex, paras 9–11

21 *Ibid.*, Annex, para 18; Ev 122

22 Ev 122

23 HM Treasury, *Budget 2002*, p 134, Table A.1

24 IFS, *Green Budget*, January 2006, p 146

25 HM Treasury, *Tax credits: reforming financial support for families: The modernisation of Britain’s Tax and Benefit System: Number Eleven*, March 2005, p 25, para 4.5

26 *Ibid.*, p 26, para 4.9. See also Ev 121.

27 HMRC, *Child Tax Credit and Working Tax Credit: Take-up rates 2004–05*, 2007, p 12, Table 10. All references are to the central estimate.

28 Treasury Committee, Fifth Report of Session 2006–07, *The 2007 Budget*, HC 389–I, para 43

families without dependent children in 2005–06.[29] Analysis by HMRC indicated that take-up among such families had risen in that year to around 22% by caseload and 28% by value. However, the number of such families not claiming Working Tax Credit to which they were entitled had also risen—to 1,010,000—and the value of such unclaimed Working Tax Credits was £1.44 billion.[30] We consider the possible causes of these low take-up rates and measures that might increase such take-up later in this Report.[31]

Administrative problems and the 2005 reforms

13. The new tax credits have also been subject to considerable administrative problems in their early years. In 2003–04, the first year of implementation, about one-third of all tax credit awards paid were overpaid, and this trend of overpayment continued in subsequent years. The value of overpayments was £2.2 billion in 2003–04, £1.8 billion in 2004–05 and £1.7 billion in 2005–06.[32] The value of underpayments was £464 million in 2003–04, £556 million in 2004–05 and £549 million in 2005–06.[33] The recovery of overpayments by HM Revenue & Customs (HMRC) has been the source of distress and dismay to individual claimants, particularly because many of those facing recovery did not believe that an error by them was the cause of the original overpayment. We considered the problems in the administration of tax credits in detail in a Report in June 2006, in which we called for a more claimant-centred approach by HMRC.[34]

14. In December 2005, at the time of that year's Pre-Budget Report, the Government announced a series of reforms designed to improve the operation of tax credits, including:

- increasing the disregard for increases in income between one tax year and the next ten-fold, from £2,500 to £25,000;
- applying automatic limits on the amount of overpaid tax credits ("excess payments") HMRC recovers from claimants where awards are adjusted in-year following a reported change; and
- in the case of claimants who report a fall in income during the year, continuing to adjust their tax credits payments for the rest of the year to reflect their new income level but assessing whether they are entitled to a one-off payment for the earlier part of the year at the end of the year, rather than at the point at which they report the fall in income.[35]

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29 Ev 122

30 HMRC, *Child Tax Credit and Working Tax Credit: Take-up rates 2005–06*, 2008, p 12, Table 10. All references are to the central estimate.

31 See paragraphs 184–191.

32 HM Treasury and HMRC, *Tax credits: improving delivery and choice – a discussion paper*, May 2008, p 30; HC Deb, 20 May 2008, col 12WS; NAO, *HM Revenue & Customs 2005–06 accounts*: *The Comptroller General and Auditor General's Standard Report,* July 2006, p 2; *NAO, HM Revenue & Customs 2006–07 accounts: The Comptroller General and Auditor General's Standard Report*, July 2007, p 3

33 HM Revenue & Customs, *Child and Working Tax Credits statistics*, *Finalised awards, 2006–07*, April 2008, p 3

34 HC (2005–06) 811–I; HC (2006–07) 382–i, Q 7

35 HC (2005–06) 811–I, para 105

The second of these changes was due to come into effect from November 2006, but the Government subsequently delayed implementation due to administrative problems, thus prolonging the period when claimants were at risk of facing demands for full re-payments for in-year adjustments.[36] The Government has been cautious in assessing the impact of these reforms, but the increased disregard has the clear potential to benefit families whose income increases.[37]

15. In December 2005, the Government also announced new reporting obligations on claimants, the most notable of which was a shortening of the deadline for the return of end-of-year information from the end of September to the end of August.[38] A year later, following successful implementation of this change, the Government announced that in 2007 the deadline would be moved again, to the end of July, thus further shortening the period for the return of end-of-year information to four months. The Government stated that this change "will further reduce the time over which claimants are paid on potentially out-of-date information".[39]

The starting rate of income tax, tax credits and marginal deduction rates

16. The introduction of a 10 pence rate of income tax was linked by the Government to its aim of reducing the number of households facing high marginal deduction rates. Marginal deduction rates measure how much of each additional pound of gross earnings is lost through increases in tax payments and withdrawn benefits or tax credits. High marginal deduction rates are closely associated with the poverty trap, because those in work have limited incentives to move up the earnings ladder when doing so may leave them little better off.[40] Between 1997–98 and 2006–07, the number of households facing marginal deduction rates in excess of 70% fell by half a million, and the Government argued that the introduction of the starting rate of income tax played a role in that marked reduction.[41] Most of the reduction in these very high deduction rates was achieved immediately following the 1999 Budget.[42]

17. However, the introduction of the new tax credits in April 2003 has been associated with a sharp rise in the number of households facing marginal deduction rates between 60% and 70%, a number which reached around 1.5 million households following the 2006 Budget.[43] At that time, the then Chancellor of the Exchequer told us that the increase in the number of people facing marginal deduction rates of over 60% was a consequence of "more people going into work and more people claiming the Child Tax Credit or the Working Tax

36 Treasury Committee, Second Report of Session 2006–07, *The 2006 Pre-Budget Report*, HC 115, paras 76–77, 79; HC (2006–07) 382–i, Q 20

37 HC (2006–07) 382–i, Qq 6, 18–19; HC (2005–06) 811–I, paras 121–127

38 HC (2005–06) 811–I, para 106

39 HC (2006–07) 115, para 76; HC (2006–07) 382–i, Qq 18–19

40 Treasury Committee, Fourth Report of Session 2005–06, *The 2006 Budget*, HC 994–I, para 83

41 *Ibid*., para 85; *Tax credits: reforming financial support for families*, p 29, para 4.20

42 See HC (2005–06) 994–I, para 83 and Figure 2.

43 HM Treasury, *Budget 2006*, p 94, Table 4.2

Credit". He noted that he "would like to do more, and we will do more over time", but emphasised that he had succeeded in "eliminating the highest marginal tax rates". We recommended then that the Treasury analyse the characteristics and income distributions of households facing marginal tax rates in the region of 60% to 70% and the extent to which these high marginal tax rates were discouraging people from entering the workforce, from working longer hours or from acquiring additional skills.[44]

Announcements in the 2007 Budget

Overview

18. The then Chancellor of the Exchequer characterised his 2007 Budget as "a Budget to expand prosperity and fairness for Britain's families".[45] It contained many far-reaching measures, including a number which were designed for future tax years rather than the tax year about to commence. It is important to consider the abolition of the 10 pence income tax rate on non-savings income alongside the wider set of reforms to personal taxes and tax credits announced in that Budget to take effect during the period up to April 2010.[46] The IFS has argued that the measures as a whole were "carefully calibrated to ensure that various groups were protected from the abolition of the 10% band".[47]

The abolition of the starting rate of income tax for non-savings income

19. The abolition of the starting rate of income tax announced in the 2007 Budget was to come into force in April 2008. At the time of the 2007 Budget, the personal allowances for those under the age of 65 for the tax year 2008–09 were not announced. They were confirmed in the 2007 Pre-Budget Report, when the Government stated that income tax allowances for 2008–09 would be indexed in line with the increase in the Retail Prices Index for the year to September 2007.[48] The effect of abolishing the starting rate of income tax was thus to provide that individuals aged under 65 would pay the basic rate on all income after the first £5,435 up to £36,000.[49] At the time of the 2007 Budget, the Government estimated that the removal of the starting rate of income tax on non-savings income would yield the Exchequer an additional £7.3 billion in 2008–09.[50]

Reduction of basic rate of income tax

20. At the conclusion of his 2007 Budget statement, the then Chancellor of the Exchequer also announced a reduction of the basic rate of income tax with effect from April 2008 from 22% to 20%, the lowest rate for 75 years.[51] As we will see in the next chapter, for most

44 HM Treasury, *Budget 2006,* paras 83–85

45 HC Deb, 21 March 2007, col 815

46 Ev 39

47 Ev 42

48 HM Treasury, *Budget 2008*, p 131, para A.2.5

49 Ev 42

50 HM Treasury, *Budget 2007*, p 208, Table A1

51 HC Deb, 21 March 2007, col 828

taxpayers, this reduction in the basic rate offset or more than offset their losses from the abolition of the starting rate.[52] The cost to the Exchequer from this measure in 2008–09 was estimated by the Treasury to be around £8.1 billion.[53]

Higher allowances for those aged 65 and over

21. The 2007 Budget contained measures to insulate most pensioners from the effects of the abolition of the starting rate of income tax.[54] The Chancellor of the Exchequer announced increases well above indexation in the higher personal allowances for those aged 65 and over in 2008–09 and beyond. For those aged between 65 and 74, the tax-free allowance would rise in three stages from £7,550 in 2007–08 to £8,990 in 2008–09, to £9,500 in 2009–10 and then to £9,770 in 2010–11. For those over 75, the tax-free allowance would rise annually from £7,690 in 2007–08 to £10,000 by 2010–11.[55] The cost of the increases in personal allowances for those aged 65 and over in 2008–09 was estimated by the Government at £810 million.[56] Age Concern welcomed the fact that, as a result of these changes, "580,000 people aged 65 and over have been taken out of the income tax system altogether. This not only increases their income but simplifies their financial affairs by limiting their need to come into contact with HMRC."[57]

The 10% savings rate

22. Although the 10 pence rate of income tax was to be abolished on non-savings income, the Government also announced in the 2007 Budget that, "to continue to reward saving, the Government will maintain the existing 10 pence rate of tax for savings income, which is identified separately in the income tax system".[58] During our inquiry into the 2007 Budget, Mr John Whiting of LITRG argued that this change was "to make sure that the pensioner community in particular are protected from the withdrawal of the 10% main band". He acknowledged that there would be others on low income, apart from pensioners, who would benefit from the retention of the 10% savings band, but suggested that there might have been simpler ways to protect the income of pensioners than retention of a separate savings rate.[59] During the current inquiry, LITRG, Age Concern and the Tax Faculty of the Institute of Chartered Accountants in England & Wales (ICAEW) all drew attention to the complexity which the retention of the 10% savings rate added to the tax system and the practical problems for taxpayers in ensuring that they benefited from this rate.[60] The ICAEW concluded that:

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52 See paragraph 48.

53 *Budget 2007*, p 208, Table A1

54 Ev 42

55 HC Deb, 21 March 2007, col 826. For 2007–08 allowances, see *Budget 2007*, p 211, Table A4.

56 *Budget 2007*, p 208, Table A1

57 Ev 96

58 *Budget 2007*, p 106, para 5.5

59 HC (2006–07) 389–I, para 38

60 Ev 81, 97, 152; Q 86

> In the interests of simplicity, we do not think that the 10% rate should be retained in this limited way just for savings income. However, abolishing it will create further losers, and careful consideration and consultation is needed before anything is done.[61]

The 10% tax rate on savings income adds to the complexity of the tax system. Should the Government choose to remove the 10% savings rate in the future with a view to simplifying the tax system further, it should proceed with caution, ensuring that those who would lose from its abolition are clearly identified and that the precise effects of abolition are fully considered.

Changes to the higher rate threshold and Upper Earnings Limit

23. As part of his intention to create a tax system for non-savings income "that has just two rates and two thresholds", the then Chancellor of the Exchequer included within the 2007 Budget measures to align income tax thresholds with those for employee National Insurance Contributions.[62] In 2007–08, employees were paying National Insurance at 11% on their weekly earnings between the primary threshold of £100 and the Upper Earnings Limit of £670. National Insurance was then paid at a rate of 1% above the Upper Earnings Limit.[63] This created a situation in which the marginal rate of deduction faced by employees through the combination of income tax and National Insurance Contributions was 33% for weekly earnings up to £670, but only 23% for earnings between £670 and £766. In the 2007 Budget, the Government set out to address this kink in deduction rates in two stages:

- In 2008–09, the Upper Earnings Limit was to be raised by £75 a week above indexation;[64]
- In 2009–10, the higher rate threshold was to be raised by £800 a year above indexation, while the Upper Earnings Limit was to be increased further to align it with the higher rate threshold at an equivalent of yearly earnings of £43,000.[65]

The effect of these changes if implemented as originally intended would have been to create in 2009–10 a consistent marginal rate of deduction of income tax and National Insurance for all weekly earnings between £100 and around £830 of 31%. The net increase in Exchequer yield from these combined measures was estimated by the Treasury to be £1.1 billion in 2008–09 with a further increase of £1.2 billion in 2009–10, with the increases achieved through higher National Insurance Contributions from those with weekly earnings above £695.[66]

61 Ev 152

62 HC Deb, 21 March 2007, cols 826–827

63 *Budget 2007*, p 212, Table A5. The Lower Earnings Limit (LEL) is £87 per week. No National Insurance is paid by employees in respect of earnings between the LEL and the primary threshold, but National Insurance is treated as having been paid to protect benefit entitlement.

64 *Budget 2007*, p 106, para 5.6

65 HC Deb, 21 March 2007, cols 826–827; *Budget 2007*, p 106, paras 5.6–5.7

66 *Budget 2007*, p 208, Table A1

Changes relating to tax credits and Child Benefit

24. Reforms to the tax and National Insurance system in the 2007 Budget were accompanied by changes to tax credits. First, the Government announced that, from April 2008, the income threshold at which Working Tax Credit was received in full would increase by £1,200, to £6,420 a year. The Government stated that "this will support work as the best route out of poverty by increasing the gain to work for many low-income households, and reducing the net tax burden for working families".[67] The cost to the Exchequer of this measure in 2008–09 was estimated by the Treasury to be £1.3 billion.[68] This change meant that eligibility for Working Tax Credit extended in 2008–09 to those single adults without children with incomes up to around £12,900 and to those couples without children with a combined income up to around £17,500.[69] The then Chancellor of the Exchequer argued in his Budget statement that targeting expenditure on Working Tax Credit was effective in enhancing work incentives:

> More than 1½ million low-income workers in Britain receive the Working Tax Credit, worth to them on average £48 a week. In making work pay, we ensure that people on low incomes get more benefit from the Working Tax Credit than either the minimum wage or any other tax measure, whether it be the 10p rate or personal allowances. If I invested a billion pounds in helping low-income workers by raising personal allowances, they would be only 68p a week better off. If I used the same money to lower the 10p rate, they would be just 67p a week better off. But the use of the same money to extend the Working Tax Credit means that they are £7.10 a week—£370 a year—better off. That is a clear incentive to take jobs, to gain skills, and to work your way up from a lower-paid to a better-paid job.[70]

25. The benefits of the increase in the Working Tax Credit threshold were partially offset by an increase in the tax credit withdrawal rate by 2% to 39%. When the new tax credits were introduced, an award was gradually reduced at the rate of 37 pence for every pound of gross income over the threshold. The effect of the increase in the withdrawal rate is thus to make the rate of descent in payments as income increases slightly more marked, albeit from a much higher threshold.[71] The Treasury estimated that the savings to the Exchequer from the increased withdrawal rate would be £600 million in 2008–09.[72]

26. The then Chancellor of the Exchequer also announced two further measures targeted specifically on children. The Government had previously committed to increase the child element of the Child Tax Credit in line with earnings indexation, but the 2007 Budget contained an additional commitment to increase this element in 2008–09 by £150 above earnings indexation, raising it to £2,080 a year.[73] The costs of this measure in 2008–09 was

67 *Budget 2007*, p 108, para 5.15

68 *Ibid.*, p 208, Table A1

69 Ev 43

70 HC Deb, 21 March 2007, cols 823–824

71 Ibid., p 108, para 5.15; HM Treasury and Inland Revenue, *The Child and Working Tax Credits: The Modernisation of Britain's Tax and Benefit System*: *Number Ten,* April 2002, p 6, para 2.24

72 *Budget 2007*, p 208, Table A1

73 *Ibid.*, p 107, paras 5.12–5.13

estimated by the Government to be £880 million.[74] Second, the then Chancellor of the Exchequer announced that the rate of child benefit paid to the first child would rise above standard uprating so that it reached £20 a week by 2010–11.[75] The Government estimated that the combined effect of measures announced in the 2007 Budget would be to take 200,000 children out of poverty, an estimate that was subsequently supported by the IFS.[76]

The debate on the 2007 Budget

27. The fullest account of the overall rationale for the personal taxation, National Insurance and tax credits measures in the 2007 Budget was given by the then Chancellor of the Exchequer in oral evidence to us on 29 March 2007 when he said:

> On the personal tax system, it seems to me to have two rates and two thresholds is something that has eluded every Government for the last 40 years, even when they have tried to do this … We have now not only got 20p as the basic rate of income tax, and I think the public will understand the importance of that as a signal about the importance of work and the rewards that are available for work, but we have also managed to get two thresholds because the resources that we have got have made it possible for us to harmonise the threshold for top rate income tax and the ceiling for National Insurance. That is a major change that any Chancellor of the Exchequer would like to have done were the resources available to do so. That is what has lain behind what we have been able to do. Because we can provide money through the child benefit and Child Tax Credits, through pensioner tax allowances and through the Pension Credit, and through the Working Tax Credit, because these three instruments are now available to us, it is possible to move from 22 pence to 20 pence without having a 10 pence rate which in a sense was a transitional rate while we got the new system into being. I believe that over time very few people will want to change this two rate and two threshold system of income tax.[77]

The reference in this answer to the 10 pence starting rate as "a transitional rate" appears to be the first occasion on which the Government indicated that it had viewed that measure as transitional. When we asked the Treasury when the Government first stated that the 10 pence tax rate was a "transitional " measure, it made no reference to any policy statement prior to 29 March 2007.[78] The characterisation of the 10 pence starting rate as "transitional" was echoed in the current Chancellor of the Exchequer's letter to the Chairman of this Committee on 23 April.[79]

28. Given the centrality that the abolition of the starting rate has subsequently assumed in public debate, it is notable that the abolition of the 10 pence income tax rate did not dominate the parliamentary and public debate that followed the 2007 Budget. Some

74 *Budget 2007,* p 208, Table A1

75 HC Deb, 21 March 2007, col 825; *Budget 2007*, pp 111, 214, paras 5.20, A.31

76 HC Deb, 21 March 2007, col 825; HC (2006–07) 389–I, para 47

77 HC (2006–07) 389–II, Q 296

78 Ev 129

79 Ev 120

concerns were expressed: the TUC pointed out that "there may be a group of younger, childless, non-disabled, low-paid workers who do not qualify for tax credits who could lose out".[80] Geoffrey Robinson MP, a former Treasury Minister, said the following during the debate on the Budget resolutions:

> I have a bone to pick with the Chancellor of the Exchequer and the Treasury Front Bench about the removal of the 10% … rate. I cannot believe that that is the last word from my right hon. and hon. Friends on the subject. It is hurting many people whom the Government never set out in any of their policies to hurt—I accept that that is a consequence and not an intention of the Budget. Indeed, when the 10p rate was introduced it was precisely to alleviate those problems that, in part, we are now creating. I know that there are tax benefits and that there are many other things that we have done for that category of taxpayer, but the matter should be revisited, and I hope that we will do so before the next Budget.[81]

When it was put to the Rt. Hon. Stephen Timms MP, the then Chief Secretary to the Treasury, at the conclusion of the debate on the Budget resolutions that a single person without children who earned less than £18,000 a year would be worse off as a result of the Budget, he replied "No, that is certainly not necessarily the case".[82]

29. The most authoritative quantitative analysis of the 2007 Budget package available at the time was provided to us by the IFS on 26 March 2007, when Mr Robert Chote, Director of the IFS, gave an estimate that 5.3 million families lost as a result of the package, although he also stated that "most of them don't lose very much".[83] On 28 March, Mark Neale, Managing Director, Budget, Tax and Welfare, HM Treasury, said in evidence to us that "the figure that Robert Chote gave you is in the right ball-park".[84] The following day, in Treasury questions and in evidence to us, the then Chancellor of the Exchequer did not directly answer questions about the numbers who were worse off as a result of the Budget, but argued that the IFS figures did not take account of the rise in the minimum wage or the behavioural impact of changes to Working Tax Credits.[85] In evidence to us he also provided new information about take-up of Working Tax Credit.[86] In our Report, we welcomed evidence of a recent increase in take-up of Working Tax Credit and argued that increasing the low take-up rate of Working Tax Credit among those entitled to claim it without dependent children should be a priority.[87]

30. Because the main tax changes announced in the 2007 Budget were not due to come into force until 2008–09, they were not included within the 2007 Finance Bill, but, during the report stage of that Bill in the House of Commons, Mr Frank Field MP moved a new

80 Ev 108

81 HC Deb, 27 March 2007, col 1365

82 *Ibid.*, col 1430

83 HC (2006–07) 389–II, Q 61

84 *Ibid.*, Q 189

85 HC Deb, 29 March 2007, cols 1619, 1622; HC (2006–07) 389–II, Qq 303–308

86 HC (2006–07) 389–II, Q 312

87 HC (2006–07) 389–I, para 45

Clause which, if enacted, would have required the Government to identify the effects of tax measures on different earnings groups and prepare transitional relief measures for those within the lowest quintile of earnings who were adversely affected.[88] In the course of the debate on that new Clause, Mr Field referred to a written parliamentary answer from HM Treasury which he considered implied that there were 3 million individual taxpayers who would lose from the abolition of the 10 pence rate of income tax coupled with the reduction in the basic rate.[89] In reply to the debate, the then Chief Secretary to the Treasury said:

> The package reduces and simplifies personal taxation within a fiscally neutral Budget, protecting and boosting the incomes of vulnerable groups, with the number of losers minimised. I am not saying that there are none, but the number has effectively been minimised … If we all agree—I think that on the whole we do—that it is right to prioritise the reduction and ultimately the eradication of child poverty, we need to prioritise households with children in Budget measures. That is what the package in the Budget does … As far as I can see, where losses accrue to some as a result of the changes, they are small.[90]

The new Clause was rejected by the House after a division.[91] Subsequently, on 18 October 2007, the Treasury published a parliamentary written answer to a question from Mr Field which stated that "5.3 million households … will pay marginally more in net tax" as a result of the changes coming into effect in 2008–09.[92]

The 2007 Pre-Budget Report

31. The Chancellor of the Exchequer's 2007 Pre-Budget Report, published alongside the Comprehensive Spending Review on 9 October, did not contain measures with a direct bearing on income tax, beyond the announcement of the indexation of allowances to which we referred earlier.[93] It did, however, contain a number of measures relating to tackling child poverty, measures which are relevant to the overall impact of the tax changes in the 2007 Budget.

32. First, the Government announced that it would raise the child element of the Child Tax Credit by £25 a year above earnings indexation to £2,085 in 2008–09, in addition to the commitment in the 2007 Budget to increase the child element by £150 and that it intended to raise the child element again by a further £25 above indexation in April 2010.[94] The cost of this measure in 2008–09 was £150 million, rising to £310 million in 2010–11.[95] Second,

88 HC Deb, 25 June 2007, cols 108–110

89 *Ibid.*, col 121: "In 2008-09, all 31 million taxpayers would have benefited from the 10p rate of income tax. Some 28 million of these taxpayers stand to gain from the cut in the basic rate of income tax to 20p": HC Deb, 25 June 2007, col 384W.

90 HC Deb, 25 June 2007, cols 119–120

91 *Ibid.*, col 122

92 HC Deb, 18 October 2007, col 1267W

93 See paragraph 19.

94 HM Treasury, *Pre-Budget Report and Comprehensive Spending Review 2007*, p 78, para 5.25

95 *Budget 2008*, p 112, Table A.2

the Chancellor of the Exchequer announced that he was doubling the amount of child maintenance that a family could receive without affecting their family benefits to £20 a week in 2008–09 and then to £40 a week in 2010–11.[96] Third, the Government confirmed that it would introduce nationally the previously piloted In-work Credit, a £40 a week (£60 in London) payment for lone parents who had been on Income Support during their first twelve months in employment.[97] The Government estimated that the combined effect of these measures would be to lift 100,000 children out of poverty.[98]

The 2008 Budget

33. Like the 2007 Pre-Budget Report, the 2008 Budget held on 12 March contained no substantive new measures with a direct bearing on levels of personal taxation planned to come into effect in 2008–09. However, it did contain measures affecting overall household income targeted on pensioner households and certain households with dependent children.

34. In addition to the Government's prior commitment to continue the level of the Winter Fuel Payment at £200 for households with someone over 60 and £300 for households with someone over 80 for the duration of the current Parliament, the Government announced extra one-off payments in 2008–09 which made the totals to be paid £250 and £400 respectively.[99] The cost to the Exchequer of these one-off payments in 2008–09 will be £575 million.[100]

35. The 2008 Budget also contained three measures relating to child poverty. First, the rate of Child Benefit for the first child was to be raised to £20 a week in 2009–10, a year earlier than had been announced in the 2007 Budget, at a cost of £210 million in 2009–10.[101] Second, the child element of Child Tax Credit was to be increased by £50 a year above indexation from 2009–10, at a cost of £340 million in that year.[102] Third, receipt of Child Benefit was to be disregarded in calculating income for the purposes of Housing Benefit and Council Tax Benefit, at a cost of £350 million in the first full financial year in which it has effect.[103] The Chancellor of the Exchequer said that the combined effect of these measures would be to lift 250,000 children out of poverty, an estimate which the IFS broadly endorsed.[104] Of this eventual reduction, the Chancellor of the Exchequer attributed a reduction of around 150,000 children to the Child Benefit disregard alone.[105] Mr Mike

96 HC Deb, 9 October 2007, col 172

97 *Pre-Budget Report and Comprehensive Spending Review 2007*, p 75, para 5.12

98 HC Deb, 9 October 2007, col 173

99 *Budget 2008*, p 65, para 4.29

100 *Ibid,*, p 110, Table A.1

101 *Budget 2008*, p 63, para 4.17, p 110, Table A.1

102 *Ibid.*

103 *Ibid.*

104 HC Deb, 12 March 2008, col 291; Treasury Committee, Ninth Report of Session 2007–08, *The 2008 Budget*, HC 439, para 50

105 HC Deb, 12 March 2008, col 290

Brewer, Director of Direct Tax and Welfare at the IFS, told us that he viewed the measure as well-targeted on child poverty.[106]

Developments since the 2008 Budget

36. When we took evidence from Treasury officials on 18 March during our inquiry into the 2008 Budget, we sought and failed to obtain a direct answer to the question of how many people with an income of less than £18,500 would face a fall in their living standards in 2008–09 as a result of the abolition of the 10 pence rate of income tax and other measures.[107] In written evidence received the following day, the Treasury stated that 800,000 single earners with income under £18,500 would see their income decrease by around £1.45 a week on average, with the maximum loss to any individual being £232 a year (£4.46 a week)—about 3% of net income.[108] When we raised these figures with the Chancellor of the Exchequer on 19 March, he acknowledged that there were people who would be adversely affected by the measures in the previous year's Budget. With respect to those aged 60 to 64, he drew attention to the benefits of the additional winter fuel payment. He also said that "we have tried to help wherever we can through the tax credit".[109] In our subsequent Report we concluded:

> Those most affected by the abolition of the 10 pence rate of income tax appear to be those below the age of 65 with an income under £18,500 who are in childless households. The effect is greatest on those households where no individual is above the age of 60 because the household does not then benefit from the higher winter fuel allowance. We accept that there are benefits in tax simplification and that there are merits to focus on both the needs of children and motivation to work. However, the group of main losers from the abolition of the 10 pence rate of income tax seem an unreasonable target for raising additional tax revenues to fund these and other initiatives.[110]

37. Our views were part of a growing chorus of concerns about the effects of the tax measures as they came into force in the new tax year. The postbags and inboxes of Members of the House of Commons began to bulge with letters and e-mails expressing concern about the effects of the removal of the starting rate of income tax. That decision dominated the debate on the Second Reading of the Finance Bill on 21 April, during which the Rt. Hon. Yvette Cooper MP, the Chief Secretary to the Treasury, announced that the programme of work already underway on the next phase of tackling child poverty would be extended "to include consideration of households on low incomes without children".[111]

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106 Q 50

107 HC (2007–08) 430, Qq 234–241

108 *Ibid.*, Ev 63

109 *Ibid.*, Qq 385–386

110 *Ibid.*, para 61

111 HC Deb, 21 April 2008, col 1067

38. Two days later, on 23 April, the Chancellor of the Exchequer wrote to the Chairman of this Committee indicating an intention to "do more to help" certain groups "now and in the future":

> The main two groups we want to do more to help are, first, other low paid workers without children, and, second, pensioners under 65. We have been actively looking at two ways to help these groups—direct payments or changes to the tax credit system … As a sign of the Government's intent, we do not wish to wait unnecessarily until [the Pre-Budget Report in] November. Whatever conclusions we come to, all the changes [through direct payments] will be backdated to the start of this financial year.[112]

These remarks were echoed on the same day by the Prime Minister, who also said that measures relating to Working Tax Credit considered for the Pre-Budget Report would relate "to young people and part-time workers".[113] In the light of the announcements made on 23 April and the outcome of a preceding meeting between Mr Frank Field and the Prime Minister, Mr Field did not proceed with an amendment at the Committee stage of the 2008 Finance Bill similar in effect to that which he had tabled to the 2007 Finance Bill.[114]

39. On 13 May 2008, the Chancellor of the Exchequer announced that he proposed to table an amendment at the report stage of the Finance Bill to increase the individual personal tax allowance by £600 to £6,035 for the current financial year, benefiting all basic rate taxpayers under 65.[115] We examine this announcement in more detail in chapter 4. However, before looking at options and decisions for the current tax year, it is important to look in detail at the initial effect of the abolition of the starting rate of income tax and related Budget measures.

112 Ev 120

113 HC Deb, 23 April 2008, col 1302

114 See paragraph 30 and HC Deb, 28 April 2008, cols 111–116.

115 HC Deb, 13 May 2008, col 1201

3 The initial effects of abolition and related Budget measures

The purpose of this chapter

40. This chapter seeks to analyse the impact of the abolition of the 10 pence starting rate of income tax as it was intended to be implemented prior to the announcement of 13 May 2008 in the context of other Budget measures. It is important to analyse this impact for several reasons:

- That analysis relates to the direct tax burden that is currently faced by individuals and households in the United Kingdom and will be faced by them until September, albeit with the prospect of a reduction in that burden with retrospective effect;
- It provides the context for understanding the options considered and the decision eventually taken on 13 May relating to the current tax year;
- It provides an essential part of the context for understanding the options for future tax years, given that the Government is not committed to making the changes announced on 13 May a permanent feature of the tax system; and
- It sheds light on the quality and comprehensiveness of the information available to and provided by the Treasury about the impact of the measures announced in the 2007 Budget.

The measurement issues

Overview

41. When considering who has lost or gained from a taxation measure outlined in a Budget, the first consideration must be the losses and gains derived from the reform to the taxation system alone, without regard to any other changes in the tax credit or benefit systems that may be occurring at the same time. The second consideration must be to then add in any reforms to the tax credit and benefit systems that may affect an individual taxpayer, or the household in which that individual taxpayer resides and which might reasonably impact on that individual. There may then be further measures that benefit the individual, such as those measures relating to dependent children, which have to be accounted for in calculating gains and losses at a household level. As such, the number of gainers and losers from an overall package announced in a Budget may not be immediately transparent.

Unit of measurement: individual versus household

42. One of the more complicated aspects of our inquiry has been the different units of measurement used to identify the numbers of losers. The personal taxation system is based on an individual's level of income, and has no regard to the other people that taxpayer may

live with, or how taxpayers may share their individual income within a household. This has been the case since the introduction of personal taxation in 1990.[116] Witnesses at other inquiries we have undertaken have emphasised the importance of individual taxation. In 2006, Dawn Primarolo MP, then Paymaster General, in describing the operation of the tax credit system to the Sub-Committee, highlighted both the interrelated nature of the tax and tax credit systems, but also the importance of the idea of independent taxation:

> The award notices have two functions, of course, and one is to do with independent taxation because under independent taxation we notify individuals direct and with the tax credit system we are using household income because it was to be paid to the main carer, normally the mother, so 80% plus will go to women. When we send out award notices we ensure that both individuals in respect of independent taxation get those award notices. What has happened therefore is that every change that occurs to the information that the computer has immediately generates to both because as a woman I am going to defend independent taxation, and I am sure you would; it took women a long time to get independent taxation.[117]

43. However, the Government often uses the 'household' as a measurement unit. For instance, it is used by HMRC when operating the tax credits system. In its evidence to us, the Treasury emphasised this important difference between the operation of the taxation and tax credit systems when calculating the number of losers, and why the Treasury prefers using households as a measurement unit:

> Budget 2007 announced a number of measures to income tax, national insurance and tax credits. Income tax and national insurance operate on an individual basis. In contrast tax credits are awarded to a family based on their family income and it is difficult to assign these to one individual in the family when the whole family benefits. All the parts of the package were designed to complement each other so the impact of the package needs to be looked at as a whole; looking at any aspect of the package in isolation would give an incomplete picture. For these reasons the Government's analysis is on a household basis.[118]

Unit of measurement: household versus family

44. The IFS and the Treasury use different definitions of households when presenting their analysis. In a memorandum prepared at the request of the Committee, the Treasury explained the difference between the two measures:

> A household is defined as all persons living at the same address who either share one meal a day together or share the living accommodation (i.e. living room). A benefit unit, hereafter referred to as a family or family unit, consists of a single person or a man and a woman living together who are married or are living together as if they were married. Dependent children are allocated to their parent's family unit and are

116 IFS, "A survey of the UK tax system", *Briefing Note 9*, November 2001, p 29

117 HC (2005–06) 811–II, Q 327

118 Ev 124

defined as any person under 16 or any unmarried 16-19 year old eligible for child benefit. Same sex couples were treated as separate families until late 2005.[119]

The Treasury then went on to explain the reasoning behind the difference:

> the IFS have presented their analysis for families and HMT for households. As many income-related benefits and tax credits are allocated to a family based on family income it is difficult to assign these to an individual and therefore to produce "winners" and "losers" at an adult level. The IFS opted to produce analysis of the overall package at the family level for this reason. This is a perfectly valid choice, and one that HMT does not dispute.
>
> HMT, however, chooses to produce analysis on households. There are several reasons for this. Housing benefits take into account the income of all "family" units in a household. If income changes for a non-dependent in a household receiving housing benefits, it may affect the amount of housing benefit or council tax benefit received by the family claiming these benefits, even if their income does not change.[120]

The IFS provided the following explanation as to what such an identification would mean when considering the analysis of the losers and winners from the abolition of the starting rate of income tax:

> The distributional analysis done by the Treasury is usually performed at the 'household' level (in other words, income of all individuals in a household is added together, so that a fall in income experienced by one adult might be offset by a gain experienced by someone else in the household). As we show later, fewer (in absolute and proportionate terms) households lose than families, often reflecting the fact that parents who gain could compensate offspring living at home who lose, although they may choose not to do so.[121]

Defining a losing 'unit'

45. There was also a difference between how the IFS and the Treasury defined a losing family or household. According to the Treasury, it

> judges a household to be a 'loser' if the household has a fall in weekly net income of more than 5p, and a 'winner' if the household has a gain in weekly net income of more than 5p. The IFS uses a level of +/- £1 per week to assess if a household has 'won' or 'lost'.[122]

119 Ev 171

120 *Ibid.*

121 Ev 40

122 Ev 172

Why units of measurement are important

46. Understanding the units of measurement are important for two reasons. First, differences in method help to explain why the Treasury and the IFS might not agree on the final numbers, or characteristics, of losers. For example, a 'losing' individual might be a young man or woman, living at home with his or her parents but no longer dependent on them. The IFS model would see this person as one 'family', and place them in their age range for statistical purposes. The Treasury would place them in a household headed by whoever was the Household Reference Person—the person who owns the home, or is legally responsible for the rent[123]—who could be somewhat older. The Treasury memorandum explains the impact of this distinction:

> The IFS analysis suggests 0.5 million adults aged under 25 paying more tax and not receiving tax credits to offset the increase. These families will not show in HMT analysis as many of them will live in households with other adults. These other adults may gain more to offset the losses incurred by the under 25 year old.[124]

47. The other reason why the differences are important is that the tax system operates on an individual basis, and that individual may not wish to regard themselves as part of the household as defined by the Treasury. For instance, a household overall may have benefited from the changes announced in the 2007 Budget and the subsequent Pre-Budget Reports and Budgets as intended to be implemented prior to 13 May, because one earner in the household received a higher income than the other earner, and thus the higher earner's 'gain' outweighs the other earner's 'loss'. However, on an individual basis, one earner had still been made worse off, and may have regarded themselves as a 'loser' from the Budget.

Those who benefit or are not adversely affected

48. The measures announced in the 2007 Budget led to most taxpayers gaining, principally because for most taxpayers the loss from the removal of the 10 pence tax rate was more than offset by the gain from the reduction in the basic rate of income tax from 22 pence to 20 pence. The IFS identified the following 'gainers' from the reduction in the basic rate:

> Most people aged under 65 with non-savings income between £19,355 and around £40,000 gained noticeably from the Budget 2007 income tax changes, with the biggest gain, of £336 a year, at an income of £36,140. These people gain more from the cut in the basic rate than they lose from the abolition of the 10% band and the rise in the upper earnings limit for National Insurance Contributions.[125]

The LITRG also identified for us the following gainers from the personal tax changes:

> Once an individual's income is above a certain level, they win from the changes no matter what their circumstances. That level in simple terms is some £17,500; taking

123 Ev 127. For a further discussion of the Household Reference Person, see paragraph 88.

124 Ev 127

125 Ev 42

> into account the increase in personal allowances, the break point comes down to £16,500. If somebody is in work throughout the year, and therefore paying [National Insurance Contributions] consistently, the break point comes down further to £15,500.[126]

49. The LITRG also identified those who did not gain from the main changes in income tax bands and rates, but gained through the other measures in the 2007 Budget that we described earlier:[127]

> There is also compensation for those aged 65 and over (whose personal allowances rise beyond the level needed to compensate); and for those who claim and receive tax credits, through above-inflation increases in the first income thresholds for claimants of both Working Tax Credit … and Child Tax Credit … and a substantial increase in the amount payable under Child Tax Credit in respect of each child.[128]

The IFS confirmed this point, describing the 2007 Budget as "closely calibrated" so that certain groups were protected from the effect of the loss of the 10 pence rate of tax, so that:

> no individual aged 65 or more was paying more income tax as a result of the reforms, and many were paying less because of the rise in the extra tax allowances for those aged 65 or more [and] single-earner families receiving tax credits were no worse off as a result of the reforms (because of the increased generosity of the Child and Working Tax Credits). Those with children were mostly better off.[129]

The losers

The overall number of losers

50. The initial estimate from the IFS was that there were 5.3 million 'losing' families from the measures announced in the 2007 Budget. The IFS definition of a losing family was one that lost more than one pound a week.[130] The 5.3 million families figure was based on the assumption that there was full take-up of all available tax credits and benefits.[131] Estimates by the IFS at the time of that Budget suggested that if no single person took up Working Tax Credit, the number of losing families would rise to 5.9 million.[132] In their written evidence for our inquiry, the IFS then updated these figures:

> Recalculating the number of losers taking account of all measures in Budget 2007, PBR 2007 and Budget 2008, we now estimate that 5.2 [million] families would have fallen into these categories and been worse off, if all those entitled to tax credits took

126 Ev 79

127 See paragraphs 24–26.

128 Ev 79

129 Ev 42

130 Ev 40, 42

131 Ev 40

132 HC 389 (2006–07) 389–II, Q 62

> them up. If no-one without children took up the Working Tax Credit to which they were entitled, the number of families losing would have been 5.4 [million].[133]

The number of losing families lies somewhere between these two figures, because, according to data released by HMRC, take-up of Working Tax Credits among households without dependent children rose to 28% of money being claimed in 2005–06 and to 22% in 2005-06 when measured by caseload.[134] The Treasury also released its own estimate of the number of losers, in a parliamentary answer in October 2007. It stated that 5.3 million households (rather than families) had lost, using the Treasury's definition of loss.[135]

Losers in terms of amounts lost

51. The overall calculation of the amounts lost per week, on a household or family basis are, of course, dependent on the circumstances of that household. Numerous factors would determine whether a household or family did or did not lose out from the abolition of the 10 pence rate of tax as initially implemented, including the number of earners within a household, the age of the earners in the household, the incomes of earners in a household, whether or not they were eligible, and had taken up, any benefits and/or tax credits and whether a household or family had dependent children. The IFS stated that the following groups were the main losers when the tax changes were taken in isolation from any other changes:

> People aged under 65 with non-savings income between £5,435 and £19,355 would have paid more income tax as a result of the Budget 2007 changes, because they lost more from the abolition of the 10% rate than they gained from the cut in the basic rate. This loss is greatest, at £232 a year, for someone earning £7,755, the top of where the 10% band would have been.[136]

The TUC pointed out that this would mean that "the worst losses [are] concentrated on those earning around £150 a week".[137] CPAG emphasised that this maximum loss of £232 a year was on an individual basis.[138] As such, a couple each of whom earns £7,755, both of whom are aged 24 (and thus not eligible for Working Tax Credit) and claiming no other type of benefit could conceivably lose £464 a year as a household.

52. In its written evidence to us, the Treasury provided information we had requested for the distribution of the annual losses by type of household, which can be seen in Table 1:

133 Ev 43

134 Ev 122

135 HC Deb, 18 Oct 2007, col 1267W. See paragraph 45 for a description of this definition of loss.

136 Ev 42

137 Ev 108

138 Ev 103

Table 1: Distribution of annual losses in income tax payments in 2008–09 under system as planned to be implemented prior to 13 May by household type

		Proportion of households paying more net tax (%)				
		Under £50	£50-£100	£100-£150	£150-£200	Above £200
Households containing individuals	Aged 60-64	27	22	19	16	17
	Economically inactive and aged under 60	22	15	19	21	23
	Economically active and eligible for Working Tax Credit	29	24	18	13	16
	Economically active and not eligible for Working Tax Credit	22	22	17	18	21

Source: Ev 128

Those between 60 and 64

53. To a very large extent, those aged 65 and over were insulated from adverse consequences of the abolition of the 10 pence rate of income tax because of the increases in allowances for those aged 65 or over that we noted earlier.[139] The IFS noted one exception to this protection: in certain unusual circumstances it was possible for someone aged 65 or over to lose, notably if they had non-savings income (including pension income) below £19,355 and savings income above £9,635.[140] However, the State pension age for women born on or before 5 April 1950 is 60, compared with 65 for men.[141] This difference meant that some women aged 60 to 64, in receipt of the State Pension, were losers from the abolition of the 10 pence rate of tax, and were not compensated by the increased personal allowances for those over 65. There may be particular reasons why the effect was greatest on women aged 60 to 64, including the fact that on average women have lower levels of occupational pension provision and lower levels of benefits where they have an occupational pension. The Pensions Commission's analysis, for example, showed that:

> Current female pensioners receive much lower levels of occupational pension because during working life they had much lower levels of employment, a greater tendency to be in part-time work, lower average earnings, and a greater tendency to work in service sectors where pension provision was less prevalent.[142]

Ms Teresa Perchard, Director of Public Policy, Citizens Advice, suggested that for this group of people, the loss could be significant:

> Certainly the initial impact of the abolition of the 10p tax rate brought a lot of pensioners aged 60 to 64 into [Citizens' Advice Bureaux], who were reporting they expected a doubling of their tax bill (quite small amounts of money but big for them)

139 See paragraph 21.

140 Ev 42

141 The Pension Service, *A to Z: State Pension*, available at www.thepensionservice.gov.uk

142 Pensions Commission, *Pensions: challenges and choices, First Report of the Pensions Commission*, October 2004, p 262

> up from £5 a week to £10 a week, and they were a bit shocked about what they were going to do.[143]

Ms Perchard went on to give an example that highlighted the particular difficulties for this age group the loss of the 10 pence tax band had caused, against a backdrop of rising prices:

> It tended to be women of 60–61 up to 64 with a mixture of income from state retirement pension and some private pension who were suddenly faced with paying twice as much tax as they were earlier this year. In one particularly good case, somebody's tax liability went from £400 a year to £600 a year and she did not know how she was going to afford the £200. Her combined income from all pensions was £8,500, she was a homeowner, with too large an amount of savings to qualify for other means-tested benefits, so you might say she is quite well off, but she is in her early 60s, she has a small amount of savings to see her through, and often we are finding people are using that to pay fuel bills as well.[144]

54. During our inquiry into the 2007 Budget, Mr Chote told us that there would be 0.3 million losing women in this category.[145] During the current inquiry, the trade union UNITE and the Civil Service Pensioners' Alliance put the figure somewhat higher:

> Statistics from the Department for Work and Pensions indicate that 0.6 million women aged between 60 and 64 will see their income decreased by £1.95 a week on average.[146]

There are also men in this age group who may be adversely affected. This point was made by Age Concern, who told us they had "also heard from men aged 60 to 64 and people approaching 60 who are either retired or on low earnings".[147] However, such men have retired early in the eyes of the State, and we consider them in the next section.

Those who retired early

55. Apart from those women aged 60 to 64, who are regarded by the State as pensioners, there are a number of people who have retired before State pension age, including men aged 60 to 64. These early retirees are particularly vulnerable to changes in the taxation system, because they are no longer working, and therefore cannot undertake certain coping strategies, such as increasing their hours, that those who are economically active can undertake. Age Concern noted that:

143 Q 2

144 Q 43

145 HC (2006–07) 389–II, Q 61

146 Ev 156

147 Ev 96

> It is particularly difficult for those who are already retired, perhaps having been forced to stop working due to ill health or redundancy, and have little option of increasing their income.[148]

Mr Whiting highlighted the problems faced by this group of people:

> I have come across a number of people who have genuinely taken early retirement in their late 50s, who by their nature have probably worked out quite carefully what their package was, they are articulate, they have spotted this during the last year and I have dealt with many of them who of course have seen this.[149]

Age Concern also noted the care with which some of those within these affected groups planned their finances:

> People in their late 50s who were forced to leave work due to ill health or retired early, perhaps to provide care or be with an older partner. These groups also feel aggrieved that having planned their finances tax rules have changed.[150]

56. Some may have been forced into early retirement by disability. We consider in the next section those on incapacity benefit, but the TUC highlighted the problems faced by this particular group of people:

> Retired people aged under 65 with low incomes include people who were forced by the onset of disability into early retirement and rely on occupational pensions paid at a reduced rate because of the age at which they began claiming. Some are widows with very small survivors' pensions; others are people pushed into retirement by organisations with a mandatory retirement age of 60. These groups may be small, but they are all very deserving.[151]

Joan Walley MP, the Member of Parliament for Stoke-on-Trent North, highlighted that there were geographical clusters of people who had been forced to take early retirement:

> The effects of the abolition were felt strongly in my constituency, a former coal mining community which is ranked 15th in the 2007 index of deprivation. There are characteristics unique to former coal mining communities such as Stoke-on-Trent which have made people particularly susceptible to the abolition of the 10p tax rate. The heavy nature of the work has resulted in many people being forced to take early retirement, often due to ill-health. This has resulted in many people below 60 years of age, claiming a pension, who have seen their tax increase markedly as a result of the changes.[152]

148 *Ibid.*

149 Q 43

150 Ev 98

151 Ev 108

152 Ev 137

People on incapacity benefit

57. Incapacity Benefit is a taxable benefit, once the first 28 weeks of benefit have been paid, or if the benefit was payable for a period of incapacity which began before 13 April 1995, and for which Invalidity Benefit used to be payable.[153] JobCentrePlus provides the following advice to potential claimants on the rules around permitted work:

> You can work less than 16 hours a week and earn no more than £88.50 a week, for up to 52 weeks. At the end of 52 weeks if you cannot start employment of 16 hours or more a week you must wait another 52 weeks before you apply for this type of permitted work again. While you wait, you can still work, but you must not earn more than £20 a week.
>
> You can work as many hours as you like, as long as you earn no more than £88.50 a week, if you are supervised by someone who is employed by a public or local authority, or a voluntary group, and
>
> • it is their job to arrange work for sick and disabled people
>
> • they give you regular help for you to do your job, or as part of a hospital treatment programme, and
>
> • the work is part of a treatment programme and done under medical supervision, either as an in-patient or an out-patient of a hospital or similar institution.
>
> For example, you might be working in the community, in a sheltered workshop, or as part of a hospital treatment programme. [This is referred to as supported permitted work.]
>
> Some people with serious medical conditions do not need to have a medical examination to be assessed as not being able to work. If this applies to you, you can choose how long you work for, but it must be less than 16 hours a week and you cannot earn more than £88.50.
>
> You should be paid at least the National Minimum Wage for any work that you do.[154]

58. Many of those who wrote to us to express their concern about the loss of the 10 pence tax rate were disabled. They are likely to be adversely affected by the removal of the starting rate because, if they are eligible for taxable Incapacity Benefit, and only permitted to earn up to £88.50 a week, they are in the income bracket that places them as a potential loser, but they are not able to earn more to overcome the loss even if their health allowed because of the rules governing Incapacity Benefit. Some Incapacity Benefit claimants may also be in receipt of a pension, although long-term Incapacity Benefit is not be paid to those over State pension age.[155] Capability Scotland, a Scottish disability charity, provided the

153 HMRC website, www.hmrc.gov.uk, Self assessment manual.

154 JobCentrePlus leaflet, *Permitted work: Work you can do while you receive benefits because of an illness or disability*, pp 4–5

155 Job Centre Plus leaflet, *Incapacity Benefit: Help if you're too ill or disabled to work*, p 28

following example of how on individual on Incapacity Benefit ("Mr A") was affected by the loss of the 10 pence tax rate:

> Last year [Mr A's] total taxable income was £9,790.35; and his total personal allowances were £6,955. [HMRC] then deducted his incapacity benefit – last year it was £4,227. This left him with £2,728 non taxable income. Therefore for the tax year 07–08, the first £2,720 of his pension was tax free, the next £2,150 was taxable at the rate of 10%, and the rest was taxed at 22%. He was paying a tax bill of £109.18 per month.
>
> This year he has seen a £552.01 increase in his yearly income, bringing it up to £10,342.36. His P2 for 08–09 shows his total personal allowances have also risen, to £7,235 and his taxable Incapacity Benefit has risen to £4,390. Therefore for the year 08–09, the first £2,840 of Mr A's pension is tax free and the rest is taxable at the new rate of 20%. He is paying a tax bill of £125.03 per month; a rise of £190.20 per year.
>
> If his tax situation had remained the same as last year, his tax would have gone up to £116.04 per month; a rise of £82.32 per year. Therefore, with the abolition of the 10% tax threshold he is now paying £107.88 more than he would have if it had remained.[156]

Those economically active and not eligible for Working Tax Credit

Those aged under 25

59. The SMF estimated that 1.5 million single people aged 16 to 24 without dependent children lost from the abolition of the 10 pence tax rate, because they were too young to be eligible for the compensation available through Working Tax Credit.[157] Some of those excluded from the compensation provided through Working Tax Credit by this eligibility criterion will be in public service. The British Legion pointed out that many serving in the armed forces will have found themselves in the income range that lost out from abolition of the 10 pence tax:

> It is likely that within … largely low ranking junior positions there are a high number of childless personnel aged under 25 years who are not eligible for Tax Credits. As a result they now find themselves paying more tax and not benefiting from the changes to the Tax Credits programme.[158]

Working hours eligibility

60. The IFS highlighted "families [without children] in which no adult worked 30 hours a week or more (including retirees under state pension age)" as losing from the removal of the starting rate of income tax because those families would not be eligible for Working

156 Ev 150

157 Ev 86

158 Ev 164

Tax Credit.[159] The SMF suggested that there were "250,000 single childless workers not entitled to tax credits because they work fewer than 30 hours per week".[160] Ms Perchard stated that some of these losers, ineligible for tax credits because of the part-time nature of their work would be a particular group, namely:

> carers who may be in part-time work, not looking after a child, looking after an adult, and not able to work 30 hours a week because they have got that responsibility, and we would like to have a discussion with the Government about whether there is scope to extend eligibility to Working Tax Credit.[161]

Household income eligibility

61. As we noted earlier, from April 2008, the Government increased the extent of eligibility to Working Tax Credit among single adults without children by increasing the threshold by £1,200.[162] However, some households remained unable to claim tax credits because their household earned too much, but were still affected by the loss of the 10 pence tax rate. Citizens Advice placed these people in two groups:

> Couples whose joint income is above £17,500, which pushes them beyond entitlement to Working Tax Credit, or whose award will not be enough to compensate them for tax rises on both incomes;
>
> Some single individuals (over 25) who, though paying more tax as a result of the change, are currently earning too much to be entitled to Working Tax Credit.[163]

The SMF estimated that "900,000 single childless workers earning between £13,000 and £19,000, who earn too much to receive tax credits" would be in the second group identified by Citizens Advice.[164] The IFS suggested that, prior to the implementation of the 13 May announcement of the £600 rise in personal allowances, the level of income that would have made someone ineligible for tax credits would be "around £12,900 for single adults without children, and £17,500 for couples without children".[165]

Other grounds of non-eligibility

62. Citizens Advice highlighted another group of potential losers, namely "migrant workers who meet the age and hours rules [of Working Tax Credits] but are not entitled to claim Working Tax Credit because their immigration status gives them no right to public funds".[166] The LITRG pointed out that some of these migrant families may also contain

159 Ev 43

160 Ev 86

161 Q 55

162 See paragraph 24.

163 Ev 71

164 Ev 86

165 Ev 43

166 Ev 71

children,[167] while also noting that "some migrant workers [would] be able to claim [Working Tax Credit] if their partner is not subject to immigration control".[168]

Those eligible for Working Tax Credit

63. Broadly speaking, those losing from the removal of the starting rate of income tax are those outside the tax credits system, but there are some losers among those eligible for Working Tax Credit. The first group of losers, according to the IFS, are those in families

> receiving tax credits but with two earners, each paying more income tax as a result of the reforms, where the increased entitlement to tax credits may not have been enough to compensate for two adults paying more income tax.[169]

The second group of those eligible for Working Tax Credit, but losing from the removal of the starting rate are those who do not claim their entitlement. We referred earlier to the problem of low take-up of Working Tax Credit among those without dependent children earlier, and we return later in this Report to measures to increase take-up.[170]

The losers and low-income households

64. In answer to a question asked by the Chairman of this Committee on the floor of the House on 23 April, the Prime Minister stated that:

> I have to point out to the Treasury Committee that 70% of the people who were losing under the [2007] Budget have incomes above £20,000 … It is important to recognise that of those who lost in that Budget 70% earned above £20,000.[171]

We requested clarification from the Treasury as to how this figure had been calculated. In providing clarification, the Treasury changed the unit of measurement from people to households:

> The Government analyses the impact of all Budget and PBR personal tax and benefit measures on households through HM Treasury's tax and benefit micro-simulation model. Analysis of Budget 2007 simulations show that 70% of households that pay more net tax as a result of the reforms have a household net income of more than £20,000.[172]

When we questioned Treasury officials on the difference between the two statements, Mr Jonathan Athow, responsible for Work Incentives and Poverty Analysis in HM Treasury, replied that it was "A simple confusion of people and households".[173]

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167 Ev 80

168 *Ibid.*

169 Ev 43

170 See paragraphs 12, 184–191.

171 HC Deb, 23 April 2008, col 1309

172 Ev 129

173 Q 198

65. Other evidence we have received also pointed out that low-income individuals need not belong to low-income households. The NPI stressed that "The link between low-paid workers and low-income households is weak, with only 16% of low-paid workers in a recent study belonging to households with incomes below the official income poverty line".[174] Barnardo's observed that "The majority of the losers, although by definition on low earnings, are in the middle of the household income distribution, not the bottom".[175] The Resolution Foundation sounded the following warning about the situation of these workers:

> Low earners can be overlooked by policy-makers and practitioners within government, the third sector and the private sector. They are not the poorest or most excluded yet, having only modest incomes, often struggle within the mixed economy and can fare poorly in their access to private markets, some public services and third sector provision.[176]

Understanding the impact of abolition

66. Although it is of fundamental importance to understand the details of the composition of the group who lose from the removal of the starting rate of income tax and the scale of their losses, there is a danger of seeing this as a series of segmented calculations. To do so would be to understate and misunderstand the senses of grievance and disorientation created by the tax changes. Those senses arise in part from the fact that losses have a very direct impact on those with limited, and often fixed, incomes for whom the management of personal or household finances involves what Citizens Advice characterised as "a very fine balancing act".[177]

67. The impact of the abolition of the 10 pence rate of income tax has also been accentuated by the economic circumstances in which it is coming into effect, with household budgets coming under increasing pressure from a number of sources. The credit crunch has led to a tightening of credit conditions, resulting in higher interest payments for many, even at a time when base rates have been falling.[178] The cost of living is rising at a very rapid rate by recent standards. According to Energywatch, household energy bills rose about 15% in the first quarter of 2008, contributing to Citizens Advice receiving a sharp increase in enquiries about fuel debt.[179] The price of petrol has risen by 18% in the last year and that of diesel by 30%, and the Chancellor of the Exchequer acknowledged that "people are finding the price of petrol and diesel is an increasing burden on them".[180] Food prices rose in the year to April 2008 by 7.2%, well above the overall rate of inflation.[181] The Local Government Association predicted that council tax

174 Ev 117

175 Ev 145

176 Ev 167

177 Ev 71

178 Bank of England, *Credit Conditions Survey 2008 Q1*, p 3

179 Reported in Bloomberg, "U.K. Power Bills May Rise, Adding to Inflation Woes", 6 June 2008; Ev 71

180 BBC News Online, "Treasury must end fuel plan", 22 May 2008; Q 164

181 Eurostat news release, "EU food prices up by 7.1% year-on-year in April 2008", 2 June 2008

would rise 4% this year on average, with these higher rates taking effect from April 2008.[182] The official rates of inflation, whether measured by the Consumer Prices Index or the Retail Prices Index, may disguise the actual rate of inflation for low-income households, because a higher proportion of their expenditure than that of other households is devoted to non-discretionary spending on those goods and services which are subject to some of the sharpest price increases at present. The Department for Environment, Food and Rural Affairs' (DEFRA's) *Monthly Farming and Food Brief* for April 2008 stated that "rising food prices have a disproportionate effect on low-income groups who spend a greater share of their budgets on food (around 15%) than the richest (7%)".[183] The correspondence which we as a Committee have received, and which individual Members of Parliament have received from their constituents, reflect these wider economic circumstances as well as the immediate impact of the tax changes.

Conclusions

68. **We have received and summarised very detailed information on the size and composition of the group of people who stood to lose from the removal of the starting rate of income tax as initially implemented. It must be borne in mind that the use of the household as a unit of measurement does not necessarily correspond to social realities, in that a household may not equate with a single financial unit with a shared household budget. Therefore, it is clear that this group does not exactly equate to the very poorest in society and that many within that group are not living in low-income households. The losers from the measures as initially implemented were people whose taxable income was small, and for whom the loss might be significant when required to manage a personal or household budget at a time of sharply rising prices for many essential goods and services. In assessing the impact of the removal of the starting rate as initially implemented, account also needs to be taken of the impact on those for whom their own income stream was an important benefit of independent taxation. In this context, the effect was particularly marked on women aged 60 to 64 in receipt of the Basic State Pension and modest payments from an occupational pension scheme. A significant number of that group would have been paying around twice as much income tax in 2008–09 as they were in 2007–08. The adverse effects were also magnified in some ways for those individuals paying tax, but not working, and thus less able to respond by seeking additional earnings.**

182 Local Government Association news release, "Council tax rises in line with RPI", 24 January 2008

183 Department for Environment, Food and Rural Affairs, *Monthly Farming and Food Brief*, April 2008, Annex A

4 Options and decisions relating to the current tax year

The purpose of this chapter

69. In view of the public impact of the implementation of the new direct personal taxation system for the current tax year, it became evident by the time we announced our inquiry that the Government would need to consider actions relating to the current tax year as well as future years. The Government's intention to act in relation to the current tax year was confirmed in the Chancellor of the Exchequer's letter of the following day.[184] In this chapter we survey the options that were available to the Chancellor of the Exchequer in relation to the current tax year and then explore in more detail the option that was eventually chosen and announced on 13 May.

Payments to pensioners and others

70. As we noted in the previous chapter, a substantial category of losers is composed of people between the ages of 60 and 64 with a low and generally fixed income, largely composed of women in receipt of the Basic State Pension.[185] In his letter to the Chairman of this Committee of 23 April, the Chancellor of the Exchequer outlined approaches that could be taken which would be targeted on this group:

> For pensioners aged 60–64, whose incomes tend to be more stable [than those of low-paid workers without children], we have put in hand work to see if those household who have lost out from the removal of the 10p starting rate of income tax can be helped through the mechanism that already exists to pay the Winter Fuel Allowance.[186]

71. The current Winter Fuel Allowance is paid to all households with someone over 60. It is thus not means-tested and not specific to those aged between 60 and 64. Some submissions questioned whether a comparable payment mechanism could be used to target only those aged 60 to 64.[187] The LITRG suggested that such a payment could only be targeted on this group by offsetting the gain to those aged 65 and over with a reduction in the age-related income tax allowance.[188] Age Concern argued that the mechanism used for the Winter Fuel Allowance would be the wrong mechanism to compensate people for tax changes because it would not be a means-tested payment.[189]

184 Ev 120

185 See paragraphs 53–54.

186 Ev 120

187 Ev 154, 157

188 Ev 83

189 Ev 95

Options relating to Working Tax Credits

72. The Chancellor of the Exchequer in his letter of 23 April to the Chairman of this Committee stated:

> For other low paid families currently outside the Working Tax Credit system, while we will examine in our review all practical propositions, our focus is on potential changes to the tax credits system to allow the average losses from the removal of the 10p starting rate of income tax to be offset.[190]

Later that day the Prime Minister indicated that measures relating to Working Tax Credit considered for the Pre-Budget Report would relate "to young people and part-time workers".[191] Options that could have been considered in this context included increasing the Working Tax Credit for single people without dependent children, reducing the Working Tax Credit hours rule for single people without dependent children to 16 hours, extending Working Tax Credit to those aged 16 to 24 without dependent children and a reduction in the Working Tax Credit withdrawal rate.[192]

73. The NPI stressed that any remedy to compensate losers needed to be understandable to the general public, be seen to be fair and not require people to claim back what was taken from them automatically. They opposed compensating tax losers through the tax credit system, arguing that it would not effectively target individual tax losers. They pointed out that compensating people via the tax credit system would mean saying that "you are going to compensate this low earner because they belong to a low income household but not this otherwise identical one whose household income is a bit higher". The NPI also pointed out that "the link between low paid workers and low income households is weak, with only 16% of low paid workers in a recent study belonging to households below the official poverty line". For these reasons the NPI believed that compensation delivered through the tax credit system would fail the 'fairness' test.[193]

74. Other organisations also argued against compensating people via the tax credits system. Mr Whiting told us that "the chosen route does have the advantage of being simple to administer" whereas "tax credits are themselves complex and would not hit a number of categories of people" who would continue to miss out.[194] Mr Ian Mulheirn, Chief Economist at the SMF, concurred, telling us that it was an inefficient way of targeting people who lost out as a result of the abolition of the starting rate of income tax and that it would have led to over-compensating certain groups whilst other groups of losers would not benefit from the change.[195]

190 Ev 120

191 HC Deb, 23 April 2008, col 1302

192 See Ev 90–94 for analysis by the SMF of these options.

193 Ev 117

194 Q 8

195 Q 40

75. The IPPR and SMF also highlighted the fact that many of the proposals to reform tax credits would be difficult to implement by April 2009. The IPPR, whilst arguing that there was a strong case in principle for extending eligibility to Working Tax Credit to those under 25 without children, said that "changes to the tax credit system take time to implement and it is hard to see how anyone would have received extra money until April 2009 at the earliest".[196] The SMF agreed and told us that "the tax credits system is complicated and fragile, making substantial changes difficult in short time-frames".[197] In particular, the SMF stressed that reducing the Working Tax Credit hours rule for single people without dependent children to 16 hours and extending Working Tax Credit to single people aged 16 to 24 without dependent children could be difficult to implement by April 2009.[198] The Chancellor of the Exchequer acknowledged the practical difficulties of making substantial changes to the tax credit system in a short period of time when he told the House in his 13 May statement on income tax that after examining possible changes to the tax credit system, he had concluded that "changes to the eligibility for tax credits could not be introduced this year".[199] Mr Whiting noted that the use of tax credits as the vehicle for compensation was further weakened by problems around take-up.[200]

Options relating to National Minimum Wage

76. The Chancellor of the Exchequer in his letter of 23 April stated that "the Secretary of State for Business, Enterprise and Regulatory Reform and I have asked the Low Pay Commission to report on what changes could be made to the minimum wage regime to support younger workers".[201] The Low Pay Commission was established as a result of the 1998 National Minimum Wage Act to advise the Government about the National Minimum Wage. There are currently three bands for the National Minimum Wage:

- An adult rate for workers over the age of 22, which will rise to £5.73 per hour from October 2008;
- A development rate for workers aged between 18 and 21, which will rise to £4.77 per hour from October 2008; and
- A youth rate for 16 and 17 year olds, which will rise to £3.53 per hour in October 2008.

77. While there was some support in evidence for the Government and the Low Pay Commission to examine possible changes to the minimum wage regime to increase support for younger workers, there was also consensus that, in the words of the TUC, "the case for these reforms stood on their own merits, rather than as a mechanism for delivering recompense for the abolition of the 10p band".[202] The LITRG also argued that changes to

196 Ev 114

197 Ev 90

198 *Ibid.*

199 HC Deb, 13 May 2008, col 1201

200 Q 8

201 Ev 120

202 Ev 113

the National Minimum Wage were not a cost-efficient or well-targeted way to deliver compensation.[203] The timetable for implementation of changes to the National Minimum Wage also makes it hard to envisage any such changes being relevant to compensation arrangements for tax changes in 2008–09.[204]

Options through the tax system

Overview

78. The problems identified with each of the three main potential mechanisms referred to in the Chancellor of the Exchequer's letter of 23 April led to the conclusion in the overwhelming majority of the evidence submitted that the Government was right to seek a solution to the problems created by the removal of the starting rate of income tax through the tax system itself.[205] As the LITRG put it:

> The tax system provides mechanisms that enable the right people to be compensated, whereas directing compensation through tax credits, welfare benefits or the National Minimum Wage would have risked helping some who did not lose out and missing others who did … Income tax is pretty well universal, while tax credits and benefits are targeted on individuals in specific circumstances. Hence one cannot hope by the use of tax credits or benefits to compensate all losers from this tax measure. This is why we believe that the tax system is the most accurate and reliable vehicle for ensuring full compensation reaches everyone affected.[206]

79. Within this broad consensus, there were, however, a number of different possible approaches through the tax system which are worth examining briefly before turning to the detailed examination of the actual path chosen on 13 May.

Reinstating the 10 pence rate of income tax

80. In view of the fact that the removal of the 10 pence rate of income tax in one fell swoop was the origin of the Government's difficulties with personal taxation in 2008–09, it is striking that we received little evidence advocating the reinstatement of the starting tax rate. The Exchequer revenue foregone from reinstating the starting rate without other changes would be £7.3 billion in 2008–09.[207] The TUC pointed out that 92% of the benefit of restoration would go to individuals who had not lost from the removal of the starting rate.[208] The Association of Chartered Certified Accountants was alone in arguing that the Government should "seriously consider" reversing both the substantial personal tax changes in the 2007 Budget, in other words, restoring both the starting rate and the

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203 Ev 83

204 On the current timetable, see *Low Pay Commission Terms of Reference for 2008–09*, available at www.lowpay.gov.uk.

205 See, for example, Ev 97.

206 Ev 79, 82

207 *Budget 2007*, p 208, Table A1

208 Ev 108

previous basic rate of 22 pence.[209] The LITRG referred to the possibility of, but did not advocate, reinstating the starting rate, but then clawing it back as income rose, so that income could be clawed back at a rate of £1 for every £4 of income above the starting rate limit; this would mean that there would be full recovery only when income reached about £18,000. The LITRG admitted that this solution would bring greater complexity into the tax system and add to the problem of high marginal deduction rates for those on relatively low incomes.[210]

A tax rebate or substitution programme

81. The LITRG offered two suggestions designed specifically to target those who lost from the removal of the 10 pence tax rate. The first would be to offer a rebate to those who could demonstrate that they lost out as a result of the income tax changes in 2008–09 compared with the tax they would have paid under the personal tax system operating in 2007–08.[211] The second and preferred solution would be to reintroduce the starting rate for 2008–09, but apply it only to those with incomes of less than £16,500.[212] The advantage of both these suggestions is their capacity to target losers from the removal of the starting rate very directly, minimising "deadweight costs", so that the total cost would be in the region of £1 billion. The disadvantages are that they greatly add to the complexity of the tax system and that the gains would not be deliverable until after the end of the current tax year.[213] In his statement on 13 May, the Chancellor of the Exchequer said he had considered a rebate scheme but had concluded that it would be "complex and expensive to administer".[214]

Changes to allowances

82. Beyond reinstating the 10 pence tax rate in some form, the main options for compensation in 2008–09 involve changes to allowances. Age Concern pointed out that the problems affecting pensioners aged between 60 to 64 could be eliminated or reduced by further age-related allowances, either by extending eligibility to the current higher allowance for those aged 65 and over to those aged 60 to 64, or by introducing an allowance for people aged 60 to 64 equating to the level of the standard Pension Credit guarantee rate for a single person, which would be £6,450 in 2008–09.[215] We return later to the possible use of further age-related personal allowances in future years.[216]

83. The SMF made the case for tapered personal allowances, so that the personal allowances for low-income individuals would be increased by £1,135 and tapered to the current personal allowance for incomes above £19,000. This measure would be very well-

209 Ev 149–150

210 Ev 81

211 Ev 80

212 Ev 81

213 Q 11; Ev 80, 82

214 HC Deb, 13 May 2008, col 1201

215 Ev 98

216 See paragraphs 222–223.

targeted on those losers from the removal of the starting rate, but would effectively create a different basic rate of income tax for those with earnings between the higher allowance and top of the taper. It would compensate almost all the losers from the removal of the starting rate, at a cost of around £1.5 billion.[217] The Chancellor of the Exchequer indicated that he considered tapered personal allowances prior to his 13 May decision.[218] We return later to the possible use of tapered personal allowances in future years.[219]

84. The simplest change that can be made is an increase in the personal allowance for all those paying income tax. The NPI, in a submission that reached us prior to the Chancellor of the Exchequer's own announcement on 13 May, argued that the problem with such a change was that it would benefit higher rate taxpayers. Instead, they argued for an increase in the personal allowance accompanied by a reduction in the amount of taxable income subject to basic rate tax. This was the measure the NPI recommended.[220] The NPI's proposal was similar to the option chosen on 13 May, to the detail of which we now turn.

The decision announced on 13 May

Overview

85. The 13 May announcement was of a movement in two thresholds. First, there was an increase in the personal allowance (that sum of money which can be earned before any tax is paid) by £600 to £6,035.[221] Second, in order to stop those on higher incomes benefiting from the change, the threshold after which higher rate tax (at 40%) is paid was lowered by £1,200.[222] By changing the tax bands for the entire tax year, the move was retrospective, although the benefits will not be felt before September 2008.[223] In his statement to the House, the Chancellor of the Exchequer said that the increase in the personal allowance would mean "that 22 million people on low and middle incomes will gain an additional £120 this year" and that "4.2 million households will receive as much, or more than, they originally lost".[224] While this means that most basic rate taxpayers will gain by £120 a year for this financial year, the IFS noted that those now within the range of income newly covered by the increase in the higher-rate tax band would lose some proportion of the £120. The IFS set out who would gain as follows:

> The £600 rise in the [Personal Allowance] from £5,435 to £6,035 and the corresponding change in the higher-rate threshold give £120 to almost all basic-rate taxpayers (individuals with incomes between £6,635 and £40,835), and give between

217 Ev 88–89

218 Q 202

219 See paragraph 220.

220 Ev 117–118

221 HC Deb, 13 May 2008, col 1201

222 *Ibid.*, col 1202; HMRC, *Chancellor's Announcement*, 13 May 2008

223 HC Deb, 13 May 2008, col 1202

224 *Ibid.*, 13 May 2008, col 1201–1202

> £0 and £120 to those with incomes between £5,435 and £6,035 or between £40,835 and £41,435.[225]

In his statement, the Chancellor of the Exchequer outlined his reasoning for such a generous package:

> My proposal will also provide additional support for individuals and families this year, including those on middle incomes who have benefited from other reforms announced in 2007. We are providing that support at a time when they are facing additional costs. I have brought forward this measure from the Pre-Budget Report in order to ensure that people get the benefit as soon as possible.[226]

We consider later in this Report the fiscal implications of the 13 May announcement.[227]

Implementation

86. As we have already noted, implementation of this measure will not be until September 2008, although it will then have backdated effect to the start of the tax year. The LITRG welcomed "the speed of its implementation",[228] and the SMF welcomed as its key virtue its "simplicity from an operational perspective" which allowed the Chancellor of the Exchequer to "backdate the change to April this year".[229] The simplicity of the change was picked up on by Mr Whiting, who told us that:

> When all is said and done, it is quite a simple change because of the nature of the PAYE system. Because of the data already stored they can very quickly send out instructions to employers. We have got until September to just adjust PAYE codes … what is being chosen is an administratively simple route that can just be done, that people can follow, it has a lot of attractions; the downside is … it is an expensive route and has various other implications.[230]

We asked the Treasury why it was taking until September to implement the changes. Its response was as follows:

> The Chancellor of the Exchequer said in his letter to the Treasury Select Committee on 23 April that he did not wish to wait unnecessarily until November to compensate people for the average loss households have incurred. The measures announced on 13 May were brought forward from the Pre-Budget Report because of the time needed to implement this change and so that people could benefit from the increased income tax personal allowance as soon as possible. The changes will be effective from Royal Assent, although the effects on pay packets will not be felt until September.[231]

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225 Ev 43

226 HC Deb, 13 May 2008, col 1202

227 See paragraphs 106–109.

228 Ev 79

229 Ev 88

230 Q 15

231 Ev 124

Although most welcomed the announcement of 13 May, some expressed reservations. The ICAEW noted that, while the change was simple for HMRC:

> The burden of implementing this proposed change mid-year for employees will fall on employers. We are concerned that the cost implications of this should be investigated fully before the change is implemented.[232]

The Treasury downplayed the cost to employers, and insisted that support would be available to employers, informing us that:

> HMRC and employers' representatives have long established processes in place to ensure any changes to tax can be implemented by businesses as soon and simply as possible. As part of this, HMRC is talking to employers' representatives about the smooth and timely implementation of the changes announced by the Chancellor of the Exchequer. Each year, HMRC sends a CD-ROM to employers so that they can automatically implement the annual Budget changes. HMRC will follow this well-understood process in implementing the changes announced by the Chancellor of the Exchequer. HMRC will issue an updated CD-ROM to employers, which will include all the details to enable an employer to automatically implement the changes. For smaller employers who continue to operate their payrolls manually, HMRC will provide tax tables to help them deal with the changes.[233]

Those who still lose

87. In his statement the Chancellor of the Exchequer referred to those who still lost in his statement:

> The remaining 1.1 million households will see their loss at least halved. In other words, 80%. of households are fully compensated, with the remaining 20%. compensated by at least half. In addition, 600,000 people on low incomes will be taken out of income tax altogether.[234]

The IFS provided the following analysis as to the number of people (rather than households) who would lose, and what their incomes might be:

> People aged under 65 with non-savings income between £6,635 and £13,355 are still paying more in income tax than they would have been had none of the changes mentioned above taken place. We estimate there to be around 6m people in this category (although only 2.9m are paying more than £1 a week extra in income tax). The loss is greatest, at £112 a year (equal to the original loss of £232 less the £120 cut in income tax from the rise in the personal allowance), for someone earning £7,755.[235]

232 Ev 152

233 Ev 125

234 HC Deb, 13 May 2008, col 1202

235 Ev 43

The LITRG provided the information contained in Table 2 to illustrate the impact of the changes announced on 13 May on those with particular incomes:

Table 2: Effects of changes in personal taxation from 2007–08 to 2008–09, including changes of 13 May 2008, for selected low incomes

Annual income £	Tax in 2007–08 £	Tax in 2008–09 £	Annual Gain/(loss) £
7,000	177.50	193	(15.50)
8,000	342.90	393	(50.10)
9,000	562.90	593	(30.10)
10,000	782.90	793	(10.10)
11,000	1,002.90	993	9.90

Source: Ev 80

The IFS pointed out that "many of the individuals still paying more income tax may live in families or households with someone who is paying less income tax such that the family (or household) overall does not lose".[236] As such, the IFS calculated that "After consideration of all the additional measures announced for 2008–09, we now estimate that 0.9 million families are still worse off by more than £1 a week from the measures announced in Budget 2007, PBR 2007, Budget 2008 and Finance Bill 2008".[237] The IFS also calculated that "If no-one without children claimed Working Tax Credit, we estimate there would be 1.2 million families losing".[238] The difference between the IFS estimate of 0.9 million losing families and Treasury's estimate of 1.1 million losing families was, according to the IFS, due to the fact the Treasury used the household unit of measurement, and counted all losses in weekly income above 5 pence rather than £1.[239]

88. These different methods for calculating the losers affects the information the Treasury and IFS provided on the losing families or households. The IFS described the losing families as follows:

> Of the 0.9 million families who still lose, 500,000 are single adults without children under 25, 115,000 are single adults aged 25 to 55 without children, and 140,000 are couples both aged 25 to 55 without children. Few are families with children (15,000 losers) or pensioner families (20,000 losers).[240]

The IFS then went on to note what would have happened if they had used a household unit of measurement, stating that:

> It should be noted that this analysis would have been considerably different had we examined winners and losers at the household level: although 500,000 single adults without children under 25 have lost by at least £1 a week, almost all of these live in a household with other adults.[241]

236 Ev 44

237 Ev 45

238 Ev 44

239 *Ibid.*

240 Ev 45

241 *Ibid.*

This difference became apparent from the Treasury's description of the remaining 1.1 million households that still lose. The Treasury provided the age of the Household Reference Person for the remaining losing households. A Household Reference Person is defined as follows by the Treasury:

> [The] Household Reference Person is the person who owns the home, or is legally responsible for the rent. Where there are more then one that fit this criteria, the [Household Reference Person] is the person with the highest income.[242]

Table 3 shows that most of the losing households have a Household Reference Person in the age range of 45 to 64.

Table 3: Age of Household Reference Person for households in which net income falls as a result of personal tax changes in 2008–09 as implemented after 13 May changes

Age of Household Reference Person	Number of households (million)
Under 25	0.1
25–34	0.1
35–44	0.1
45–54	0.3
55–64	0.5
65 and over	0.1
Total	1.1

Source: Ev 133

Mr Brewer agreed that many losing individuals were in households containing other people:

> Even the single adults under 25 that we identified we know that the vast majority of those are not living in households by themselves, they are living in households with other people, whether that be sharing a flat with their peers or sharing a house with their parents, so some of those young adults may be able to cope with the slight rise in their income tax bills because the people they live with are facing lower tax as a result of the Chancellor of the Exchequer's measure.[243]

The Chancellor of the Exchequer indicated that around 200,000 of the losers were in households where at least one person paid income tax at the higher rate.[244]

The impact on other basic rate taxpayers

89. The increase in the personal allowance also meant that some who had gained from the measures announced in the 2007 Budget gained further. The IFS provided the following figures as to those who gained:

> Most people aged 65 or over, and those with non-savings income between £5,435 and £6,635 or between £13,355 and around £40,000, are now paying less income tax. The biggest gain is £457 a year at an income of £36,140.[245]

242 Ev 127

243 Q 9

244 Q 221 and footnote

Mr Chote then pointed out that this meant that a significant amount of the money spent on this measure was not targeted at those who had lost:

> Of the £2.7 billion, roughly £2 billion of that has gone to people who did not need to be compensated. So roughly £700 million of the £2.7 billion has gone to the people who were still losers, the 5.3 million families that we were talking about originally, and £2 billion to a wider range of middle-income households.[246]

The SMF highlighted the difficulties of targeting such a reform, telling us that "because of the difficulty of targeting such a universal increase in the personal allowance, this is an expensive way to compensate the losers although it is relatively simple".[247]

90. However, the decision to benefit those who did not necessarily lose from the original reforms was a deliberate one. The Chancellor of the Exchequer in his 13 May statement said that:

> My proposal will also provide additional support for individuals and families this year, including those on middle incomes who have benefited from other reforms announced in 2007. We are providing that support at a time when they are facing additional costs.[248]

The Chancellor of the Exchequer then defended this decision in oral evidence, providing the following explanation:

> A number of members of this Committee and other Members of the House have said, "Why didn't you just confine what you did to help those who had lost out? Why did you go further?" I wanted to go further because I recognise that especially this year there will be many people on middle and low incomes who will be facing increased bills for gas and electricity and so on and I believed that it was better, therefore, to allow this additional help to go to all basic rate taxpayers. In doing so it supports the economy.[249]

91. The LITRG suggested that the increase in the personal allowance would mean that some of those aged 60 to 64 claiming the guarantee element of the Pension Credit, who might gain from the additional personal allowance, by doing so may lose their right to so-called 'passported' benefits—in other words, those entitlements, such as free school meals, eligibility for which is determined by eligibility for certain mainstream benefits or tax credits.[250] The LITRG explained why this might happen:

> People in the 60 to 64 age group are entitled to claim the guarantee element of Pension Credit. Therefore, some of these people would have paid more tax as a result of the withdrawal of the 10% rate, but would have been wholly or partly

245 Ev 43

246 Q 4

247 Ev 88

248 HC Deb, 13 May 2008, col 1202

249 Q 136

250 Ev 85. 'Passported' benefits are discussed further in paragraph 205.

> compensated by the fact that the reduction in their net income increased their Pension Credit entitlement, or indeed brought them into Pension Credit entitlement. Raising the personal allowance will cause some whose net incomes gave them a Pension Credit entitlement to lose that entitlement and the passported benefits that go with it. However, in tax terms, they will be better off because at those levels of income (approximately £6,500 to £6,700 a year) they will pay less tax than in 2007–08.[251]

However, the Treasury claimed that the impact of the 13 May changes on these people would not be great:

> The personal allowance change can only affect Pension Credit where someone aged under 65 is part of a claim, and as with Housing and Council Tax Benefit not all these people will be taxpayers. Guarantee Credit rose by £5 between 2007–08 and 2008–09, whilst the increase in the personal allowance for basic rate taxpayers is worth just over £2/week—so the personal allowance change alone would not taper individuals off Guarantee Credit. In addition, pensioners aged 65 or over normally have a 5-year Assessed Income Period (AIP), meaning they do not need to report changes to their retirement provision (income from capital, annuities or pension) that occur within those five years. Couples where one pensioner is over 65 and their partner under 65 are also eligible for an AIP. Overall therefore the effect of the increased personal allowance in 2008-09 on Pension Credit claimants is likely to be small.[252]

The impact on higher rate taxpaying

92. As we have already discussed earlier, the measure announced by the Chancellor of the Exchequer on 13 May was designed to not benefit those on higher-income tax rates. He provided the following reasoning for this omission:

> Higher rate taxpayers were largely unaffected by the reforms that were announced last year. So it is fair to focus this additional support on basic rate taxpayers only. However, as the £600 increased personal allowance applies not just to basic rate taxpayers but also to those paying tax at a higher rate, I am reducing the threshold at which an individual starts to pay tax at the higher rate by £600.[253]

By reducing the higher-rate tax threshold by £1,200 from £36,000 to £34,800, higher-rate taxpayers are prevented from benefiting from the measure.[254] What they gain from the rise in the personal allowance, is taken away by having to pay the higher-rate on more of their income. By reducing the higher rate threshold, the Treasury estimated that it had saved around £0.6 billion.[255] However, by lowering the higher-rate tax band threshold, the

251 Ev 83

252 Ev 135

253 HC Deb, 13 May 2008, col 1202

254 HMRC website, Helping low-income customers affected by the changes to the personal tax system announced at Budget 2007, www.hmrc.gov.uk

255 Ev 129

Treasury also estimated that around 150,000 basic rate taxpayers would be brought into the higher tax band, but stated that "all basic rate taxpayers brought onto higher rate tax by this change will gain by up to £120 from the increase in the personal allowance".[256] Although these new higher-rate taxpayers will not immediately suffer financially, they could suffer from a higher reporting burden. Mr Whiting also told us that it might have an impact on saving:

> In terms of burdens, of course at the end of the day they will still see a reduction but not as much as the £120 given to somebody on £25,000, for the sake of argument; they will do better than somebody on £50,000 who is left unaffected. The people in this band, it has already been highlighted, might start contemplating putting more into their pension fund because some of their income at least is being taxed at 40% so they will undoubtedly focus on this. This is nothing new as more and more people are being drawn into the 40% band.[257]

The impact on alignment of tax and National Insurance

93. We noted earlier that one feature of the 2007 Budget was a programme to align National Insurance contribution thresholds with those for income tax rates by April 2009.[258] However, the 13 May changes to the personal allowances and higher-rate tax band threshold have placed a question mark over this process. The LITRG pointed out that "The increase in the personal allowance on its own also reinstates the misalignment between the starting threshold of income tax and Class 1 primary and Class 4 National Insurance Contributions, a disparity which has been removed in recent years".[259] Mr Whiting set out his view as to what had happened to the alignment project in the face of the 13 May announcement:

> It left it behind! It is one of the problems and I think a number of us as soon as we heard about it started wondering, 'Just a minute, does this mean the national insurance threshold is moving?' Of course, with the emphasis on the benefit being £120, national insurance is left to one side. It will cause confusion for a number of low-paid people who now find themselves paying national insurance and not income tax but, then again, that was always the case and because of national insurance being on a weekly basis rather than cumulative, many of the low paid were already in that situation of paying national insurance when they are in work, in and out of income tax, and at the end of the year paying nothing.[260]

The ICAEW expressed concern at the lack of information on what would happen to the alignment project:

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256 Ev 125

257 Q 14

258 See paragraph 23.

259 Ev 79

260 Q 16

> The Chancellor of the Exchequer's announcement said nothing about NIC. The increase in the personal allowance means that this is no longer aligned with the primary threshold for NIC It seems likely that the change in the higher rate threshold for income tax will also have an impact on the Class 1 NIC upper earnings threshold since the Government's stated aim is to align the two. We are concerned that this announcement will have far-reaching consequences for the wider tax system which need to be properly analysed and consulted upon.[261]

94. In response, the Treasury stated that "The Government is continuing to look at the scope for further alignment of the tax and [National Insurance Contributions] systems, taking into account the changes made on 13 May, in future Pre-Budget and Budget Reports".[262] On 5 June, Jane Kennedy MP, the Financial Secretary to the Treasury, when asked about alignment in the light of the 13 May announcement, said "I am … not in a position to say exactly what we will do when we come to consider the rate of national insurance later this year".[263]

95. The SMF concluded that, should the alignment not proceed, "this effectively reintroduces some of the complexity that Budget 2007 had aimed to remove".[264] The IFS, however, outlined some of the costs associated with alignment of National Insurance Contributions thresholds with personal allowances following the changes announced on 13 May:

> Aligning the [National Insurance Contributions] earnings threshold with a maintained and uprated higher personal allowance would be extremely effective at removing losers from the abolition of the 10% band (the number would fall to 0.3 million), but at an additional cost over and above that of maintaining the higher personal allowance of £1.5 billion in employee [National Insurance Contributions] and £1.8 billion in employer [National Insurance Contributions]—thus more than doubling the cost in total. Lastly, freezing the personal allowance but increasing the NI earnings threshold to it is more costly than only indexing the personal allowance (because of the extra employer [National Insurance Contributions] revenue lost) but does lead to more families being winners.[265]

The IFS also canvassed some other policy options, including the freezing of the personal allowance in future years and then aligning the earnings threshold with it, and the Upper Earnings Limit with the new higher-rate threshold:

> This would increase income tax bills but reduce [National Insurance Contributions] for basic-rate taxpayers … If the new higher personal allowance were frozen, then the number of losers from the abolition of the 10% band would rise to 2.2 million; alternatively, a small rise in the rate of employee [National Insurance Contributions]

261 Ev 152

262 Ev 125

263 HC Deb, 5 June 2008, col 911

264 Ev 87

265 Ev 53

would make this figure 1.5 million. Compared with the position if the 2008–09 personal allowance were maintained and conventionally uprated, freezing the personal allowance would create 8.3 million losers and increasing [National Insurance Contributions] 9.6 million losers, compared with 3.0 million if the personal allowance were indexed (many additional families would lose by less than £1 a week, which we count as being broadly unaffected).[266]

Conclusions

96. **The Chancellor of the Exchequer's letter to the Chairman of this Committee of 23 April referred to the possibility of taking action in response to concerns about the removal of the starting rate of income tax through the mechanism used for making winter fuel payments, through changes to the National Minimum Wage for young people and through Working Tax Credit. With regard to changes to be implemented in 2008–09, the Chancellor of the Exchequer was right not to pursue any of these options. The problem was with the tax system, and required a tax solution.**

97. In terms of the changes to be made to the tax system, the choice faced by the Chancellor of the Exchequer was, in Mr Chote's words, "between something that was cheap and complicated or something that was simple and expensive".[267] **The Chancellor of the Exchequer could have chosen to target changes to personal allowances more specifically on those who lost from the removal of the starting rate of income tax, but to have done so would have added to the complexity of the tax system. On 13 May, the Chancellor of the Exchequer made a conscious decision to introduce a broader fiscal measure the benefits of which went well beyond those who lost from the abolition of the starting rate. For the current tax year, in the circumstances which the Chancellor of the Exchequer faced, the option chosen on 13 May of increasing personal allowances, but confining the benefits to basic rate taxpayers, was probably the least bad option, with the benefits of simplicity, transparency and greater incentives to work on the basis that fewer taxpayers face high marginal deduction rates. However, £2 billion of the £2.7 billion committed to that measure in the current financial year is not devoted to compensating losers from the removal of the starting rate of income tax. As such, the option chosen on 13 May represents an allocation of resources which is not directed at the Government's priorities relating to child and pensioner poverty.**

98. The changes announced on 13 May place a question mark over the process of alignment of income tax and National Insurance.[268] **The Government has failed to clarify whether it remains committed in principle to the aim set out in the 2007 Budget of aligning income tax thresholds with those for employee National Insurance Contributions. We recommend that it clarify its intentions no later than the 2008 Pre-Budget Report. Assuming that it remains so committed, we recommend that the**

266 Ev 53

267 Q 4

268 See paragraphs 93–95.

Government set out a clear path to full alignment with an accompanying timetable in that document.

99. The Chancellor of the Exchequer made it clear both in his statement on 13 May and in evidence to us that the changes announced relate to the current tax year. For future years he has chosen to emphasise the role to be played by the 2008 Pre-Budget Report.[269] **We expect decisions for future years to be taken not in isolation and separate from the normal budgetary processes, but with full regard to the fiscal context and to the broader social objectives which the Government is pursuing, matters to which we now turn.**

269 HC Deb, 13 May 2008, col 1202; Q 123

5 The broader context

The purpose of this chapter

100. Since early April, the debate on personal taxation has been concentrated almost exclusively on the question of how the Government can make amends for the abolition of the 10 pence rate of income tax. In the circumstances, this has perhaps been understandable. However, it is undesirable for individual tax policies to be considered in isolation from the broader fiscal context, not least because it encourages the notion that tax changes can be separated from their fiscal consequences. There is also a related risk that tax changes are seen solely in terms of their immediate impact on personal, family or household finances, and not in the context of the wider social objectives that the Government should be pursuing. In this chapter, we seek to redress the balance, and set the next stage of the debate in a broader context.

The fiscal context

Overview

101. We set out in our Report on this year's Budget the fiscal framework under which the Government operates. In its Code for Fiscal Stability, published in November 1998, the Government set out the principles by which it would conduct fiscal policy. The Government has two fiscal policy objectives, which are:

> over the medium term, to ensure sound public finances and that spending and taxation impact fairly within and between generations; and
>
> over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy.[270]

To achieve these two objectives, the Government has established two fiscal rules. These are:

> **the golden rule:** over the economic cycle, the Government will borrow only to invest and not to fund current spending; and
>
> **the sustainable investment rule:** public sector net debt as a proportion of Gross Domestic Product (GDP) will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40% of GDP over the economic cycle.[271]

102. In that Report we noted that the credit crunch had begun to impact on the Government's forecasts for the overall state of the fiscal position going forward. During our inquiry into the 2008 Budget, Mr Chote told us that:

270 *Budget 2008*, p 23, para 2.32

271 *Ibid.*, p 23, para 2.33

> The Treasury has effectively admitted to about a £7.5 billion permanent deterioration in the outlook for the public finances which clearly reflects in large part the movements in equity prices since the Pre-Budget Report, expectations that were described to be a sluggish or flat house price growth, associated conditions in the property market, the mix of consumer spend, consumer spending being weak relative to GDP overall, and more consumer spending going on things on which less VAT is paid. Confronted with that £7.5 billion gap they have essentially said, 'We are going to raise £2.5 billion of taxes looking five years out' and they have also tightened the assumed spending squeeze in Spending Review 2009 and are borrowing a bit more. So they have dealt with some of it by measures, some of it by assumption and some of it just by borrowing more. History suggests … there are very big variations either side of the likely path but so far it has been seven budgets running in which the errors have been in the same direction.[272]

103. This deterioration in the fiscal position had also meant that the margin by which the Government was meeting its own fiscal rules was deteriorating. Under the sustainable investment rule, under which, other things being equal, the Government attempts to ensure that net debt will be maintained below 40% of GDP over the economic cycle,[273] the Government forecast a particularly slim margin in 2010–11. For 2010–11, the Treasury forecast at the time of this year's Budget suggested that there would be headroom of only 0.2 percentage points of GDP via which the sustainable investment rule would be met, which Mr Chote suggested equated to £2.8 billion.[274] This led us to conclude in our Report on the Budget that, while "the Government has forecast that it will meet the sustainable investment rule over the period up to 2012–13 … the margin by which it is now forecasting that it will meet the rule is extremely tight, especially considering the uncertainty surrounding the overall economic situation".[275] In its response to our Report, the Government pointed out that it had so far more than met its forecast for the current deficit in 2007–08:

> Since Budget 2008, the provisional outturn from the Office for National Statistics (ONS) for 2007–08 show the current deficit, net borrowing and net debt lower in 2007–08 than expected in Budget 2008. The current deficit is provisionally £5.7 billion compared to the Budget 2008 estimate of £7.9 billion. Net borrowing in 2007–08 is provisionally £34.3 billion compared to the Budget 2008 estimate of £36.4 billion and net debt is 36.7% of GDP, compared to the Budget 2008 estimate of 37.1% of GDP.[276]

104. However, the significant downside risks to economic growth over the medium-term remain. At the time of this year's Budget, the average of independent economists' new

272 HC (2007–08) 430, Q 42

273 *Budget 2008*, p 23, para 2.33

274 HC (2007–08) 430, Q 44

275 *Ibid.*, para 36

276 Treasury Committee, Tenth Special Report of Session 2007–08, *The 2008 Budget: Government Response to the Committee's Ninth Report of Session 2007–08*, HC 689, p 3

forecasts for GDP growth was 1.6% in 2008 and 1.8% in 2009.[277] However, by May the average of these forecasts for GDP growth had changed to 1.7% in 2008—a slight improvement—but for 2009 had fallen by 0.3 percentage points to 1.5%.[278]

Spending prospects and the AME margin

105. Documents released at the time of this year's Budget contained forecasts of the Annually Managed Expenditure (AME) margin. The AME margin exists to absorb changes to spending that is not subject to multi-year control through Departmental Expenditure Limits which may arise above and beyond those forecast by the Government. The AME margin is set at £0.9 billion for 2008–09, doubling to £1.8 billion in 2009–10 and reaching £2.7 billion in 2010–11.[279] The recent rise in the claimant count points to the impact on the Government's finances from potential rises such as the need to make additional payments for unemployment benefits.[280] Another risk would be a rise in the take-up of tax credits above that expected by the Government. The crystallisation of such risks would limit the potential for the Government to use the AME margin for other purposes in future periods. The concept of the AME margin as an additional resource awaiting allocation was rejected by Mr Chote. He told us that:

> it is not free money; unclaimed tax credits are not sitting in a pot somewhere waiting to be spent. That would be new money that would need to be found if you had a doubling in the take-up of these various tax credits or benefits.[281]

The fiscal implications of the decision of 13 May

106. The decision by the Chancellor of the Exchequer to raise the personal allowance by £600 was estimated to cost £2.7 billion this financial year.[282] In his statement on 13 May, the Chancellor of the Exchequer announced that this measure would be funded by additional borrowing:

> As I made clear at the time of the Budget, it is right and sensible to allow borrowing to rise and investment to be maintained as the economy slows. Debt is lower than it was in the past and low by international standards. Our fiscal policy, like our monetary policy, is designed to support stability in these uncertain economic times generated by the turbulence in world financial markets and global commodity-price inflation. I am able to finance the proposal through borrowing this year, ensuring that we do not take money out of the economy at this time.[283]

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277 HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, March 2008, p 1, Table 1 and p 4, Table 4

278 HM Treasury, *Forecasts for the UK economy: a comparison of independent forecasts*, May 2008, p 4, Table 1 and p 7, Table 4

279 HM Treasury, *Budget 2008: the economy and public finances—supplementary material*, March 2008, p 34, Table 21

280 Office for National Statistics, *Labour market statistics*, May 2008

281 Q 39

282 HC Deb, 13 May 2008, col 1201

283 *Ibid.*, col 1202

Given the slim margin available to the Government under the sustainable investment rule, the IFS pointed out what this extra borrowing meant:

> if the tax cut had been announced at the time of the Budget, the Treasury would presumably have forecast that public sector net debt would hit the 40% ceiling in 2010–11 (measuring the net debt ratio to the nearest tenth of a percentage point as usual). If it wished to be more precise, it could claim to expect to remain £600 million below the ceiling in 2008–09 terms. If we assume that the Government is unable to claw back the cost of this 'one-off' giveaway in future years, net debt would be forecast to break through the ceiling in 2010–11, peaking a year later at 40.4% of national income – a breach of a little over £5 billion in 2008–09 terms. The Treasury would thus expect to break the sustainable investment rule as currently defined.[284]

A key issue for the fiscal sustainability of the 13 May announcement is whether the change would be permanent or not. In his 13 May statement, the only indication that the Chancellor of the Exchequer gave as to the intended duration of this measure beyond the current financial year was when he said that "For future years, our aim is to continue the same level of support for those on lower incomes and I shall bring forward proposals to do that in the Pre-Budget Report".[285] When questioned on the exact definition of those on "lower incomes" who would receive continued support, the Chancellor of the Exchequer refused to be drawn. He told us:

> I chose my words [in the 13 May statement] deliberately. I see absolutely no point in boxing myself in in May or early June in advance of the Pre-Budget Report this autumn. Our starting position was how do we help the people who have lost out, particularly people on lower incomes? Because of reasons that we will no doubt go into, the particular way I decided to do this helps a wider range of people this year. I will be looking in future years to see what we can do especially to help people on lower incomes. I am not going to box myself in to saying here is an arbitrary ceiling here or there or whatever. I will do whatever I can to help people on lower incomes.[286]

107. There is a possibility of statistical changes that may aid the Government in meeting the fiscal rules. The IFS highlighted a potential increase in the margin available under the sustainable investment rule due to a change in how the national accounts are calculated. A study by the Office of National Statistics outlined the problem faced by statisticians:

> The activity of financial services in general and of banks in particular has long been a challenging area for those who develop international standards. Market economic activity can be measured as cash values of sales and purchases of identifiable units such as cars or haircuts; these cash values can then be deflated by stripping out inflation effects to enable real growth to be derived. However the activity of banks is not so easily captured.

284 Ev 64

285 HC Deb, 13 May 2008, col 1202

286 Q 131

> For some services explicit charges are made, such as commission on foreign exchange, account charges and flat rate fees for overdrafts. But the amount of these charges is significantly below the costs paid by the banking industry on wages and bonuses, and intermediate costs such as rental, electricity and stationery purchases. So under the conventional treatment there was the threat of what the OECD described as 'the paradox of a prosperous industry showing a negligibly positive, or even negative, contribution to the national product'.[287]

The IFS provided an estimate of the potential effect this change could have on the national accounts:

> Experimental estimates by the Office for National Statistics suggest that incorporating "financial intermediation services indirectly measured" (FISIM) in the national accounts will increase the headline measure of national income by between 1.3% and 2.0% between 1993 and 2007. [288]

The IFS then calculated what such a change would mean for the margin available to the Government in meeting the sustainable investment rule. The IFS concluded that with:

> the measured level of national income increased by 2% from 2007-08 onwards, in line with the ONS's latest experimental estimates of FISIM … This lifts the debt ceiling by the equivalent of £12 billion in 2008-09 terms and means that the Treasury would not expect net debt to exceed 40% under any of the three scenarios: it peaks at 39.2% if the addition to borrowing to pay for the tax cut is for one year only and at 39.6% if it is permanent. This implies that it would remain below the ceiling by £12.4 billion if the tax cut is 'one off' and £6.5 billion if it is permanent in 2008-09 terms.[289]

However, when we asked the Chancellor of the Exchequer whether the possibility of this additional increase in the margin allowed under the sustainable investment rule had been part of the planning for the 13 May announcement, he replied "It was not part of our considerations".[290]

Conclusions

108. Mr Chote argued that an independent Bank of England would eventually neutralise any fiscal stimulus which the Government might be tempted to implement. He noted that:

> If through fiscal policy you pump a little bit of money in at the margins, you would expect that the Bank of England is likely to set interest rates slightly higher than they otherwise would be to still get the same outlook for growth and inflation that they would be happy with in the first place.[291]

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287 Office for National Statistics, 'Recording payments for banking services in the UK National Accounts: A progress report', by Geoff Tily and Graham Jenkinson, March 2006

288 Ev 64

289 *Ibid.*

290 Q 127

291 Q 6

As such, the Government is constrained in how much it can additionally borrow and inject into the economy, although the Chancellor of the Exchequer drew attention to the statement by the Governor of the Bank of England following the 13 May announcement which the Chancellor of the Exchequer summarised as being that the Governor did not think that that decision would have a significant effect on the inflationary outlook.[292]

109. **We note the evidence from the Institute for Fiscal Studies that the sustainable investment rule would be broken in 2010–11 under the Government's forecasts at the time of the 2008 Budget if the measures announced on 13 May were carried forward in future years. We also note the possibility of which we have been made aware that there may be upward revisions to Gross Domestic Product from the incorporation by the Office for National Statistics of the statistics on "financial intermediation services indirectly measured"—currently experimental estimates of how the economic activity of financial services should be measured—into the national accounts. The remaining margin was already tight following the 2008 Budget. The fiscal rules are only effective if participants and observers, including the markets, believe that the rules will be adhered to. If the Government wishes to continue to meet its fiscal rules, it will have to take them fully into account when proposing further personal tax and benefit changes.**

The Government's overall approach to tackling poverty

110. A welcome side effect of the abolition of the starting rate of income tax has been to raise the profile of the debate on poverty in the United Kingdom. Several submissions welcomed the renewed focus of policy makers on poverty, although the IPPR was concerned that now that the Government had presented its compensation package, the issue of low pay and the 'working poor' would "slip again out of the public, media and political spotlight".[293]

111. A large number of submissions to this inquiry acknowledged that the Government already had significant achievements in combating poverty. CPAG stressed that "one of the greatest successes of the current Government has been to put poverty firmly on the map" as well as helping to shape a "political consensus around the importance of tackling poverty".[294]

112. The IFS provided evidence of how different groups had fared under the impact of the Government's cumulative changes to the tax and benefit system since 1997:

> The cumulative impact of Labour's tax and benefit changes since 1997 up to and including PBR07 has been to increase the average incomes of the poorest tenth of the population by 12% and cut those of the richest tenth by 6%. But, within the poorest tenth, pensioners have gained 24% and families with children 18%, while childless working-age adults have gained only 1%.[295]

292 Q 137

293 Ev 114

294 Ev 102

295 Ev 45

The IFS went on to demonstrate that the profile of beneficiaries as a result of changes to the tax and benefit system since 1997 has been uneven with working-age families without children, in particular, gaining least or even, in some cases, losing out as a result of the Government's changes:

> working-age families without children have lost on average from Labour's tax and benefit changes across nine-tenths of the income distribution. Measured as the number of individuals living in households with incomes (adjusted for household size and composition) below 60% of that enjoyed by the average (median) household, poverty has fallen by 600,000 among children, 200,000 among working-age parents and 200,000 among pensioners since 1996–97. But poverty has increased by 500,000 among working age adults without children. All these poverty counts measure incomes before housing costs and are up to 2005–06.[296]

113. The uneven distribution of the beneficiaries from the Government's changes to the tax and benefit system was also highlighted by witnesses. Mr Peter Kenway, Director of the NPI, illustrated the trade-offs in the Government's anti-poverty strategy, telling us that "the overt targeting of child poverty and the covert targeting of pensioner poverty means that the working age in general lose out, but particularly [those of] working age without dependent children".[297] Ms Perchard told us that "there have been quite a lot of winners from the tax credit and tax packages in the last two years, particularly families with children, and some of those have won a bit more from the increase in personal allowances as well".[298] She added that:

> What seems to stand out now, however, is the people without children, particularly younger children, where they have not previously been a target for Government anti-poverty activity except with reference to minimum wage policy, and we feel that that is a group that perhaps needs more exploration.[299]

114. Mr Chote explained possible reasons why the Government had chosen to focus resources on combating poverty amongst these groups rather than amongst people of working age without dependent children:

> The Government could make an argument that says clearly you need to worry more about pensioners, who are less able to change their own circumstances, and about children, who are unable to change their own circumstances, and some of the people for example who are now left as losers (because you would expect them to climb the earnings ladder and have children) may only be in this category of still identified losers temporarily, but it fits with the overall pattern of the relative generosity of the Government's anti-poverty strategy as regards these three groups.[300]

296 Ev 45

297 Q 116

298 Q 2

299 *Ibid.*

300 Q 57

Child poverty

Background

115. In 1999, the then Prime Minister committed the Government to the goal of ending child poverty "within a generation". The pledge was underlined by setting a series of targets and milestones to reduce child poverty on the way to halving it by 2010 and eradicating it by 2020. These targets were encapsulated in the 2002 Spending Review objectives set for HM Treasury and the Department for Work and Pensions, within the framework of Public Service Agreements, to reduce the number of children in low-income households by at least a half by 2010–11 and eradicate it by 2020–21.[301]

116. The Government has said it will judge its success reducing child poverty primarily through reference to the number of children in relative low-income households, defined as households with incomes below 60% of median income. For the 2004–05 milestone of cutting child poverty by a quarter, was measured in terms of 60% of medium income both before and after housing costs. The target to reduce by one half the number of children living in poverty by 2010–11 will be measured solely in terms of income before housing costs. The Government has also said it will use two additional indicators to measure progress against tackling child poverty in the coming years:

- The number of children in absolute low-income households, defined as households with incomes of less than 60% of median income held constant in real terms from a 1998-99 baseline; and
- The number of children in relative low-income households and in material deprivation: the introduction of a material deprivation indicator for child poverty is designed to provide a wider measure of living standards and reflects the view that tackling child poverty is about more than simply raising income levels.[302]

Progress against the child poverty targets

117. The Government's initial child poverty target was to reduce child poverty by a quarter by 2004–05. The baseline for progress against this target was the Government's estimate that 4.1 million children were living in relative poverty *after* housing costs in 1998–99 and that 3.1 million children were living in relative poverty *before* housing costs in that year. By both measures, the interim target was not met. Between 1998–99 and 2004–05:

- Child poverty *after* housing costs fell by 700,000, from 4.1 million to 3.4 million. This was a drop of approximately 17%; in order to meet the target, the number would have needed to have fallen by a further 400,000 to 3.0 million.

301 HM Treasury, *2002 Spending Review: Public Service Agreements White Paper*, July 2002, p 31, para 1

302 HM Treasury, *PSA Delivery Agreement 9: Halve the number of children in Poverty by 2010–11, on the way to eradicating child poverty by 2020*, October 2007, p 5

- Child poverty *before* housing costs also fell by 700,000 from 3.1 million to 2.4 million. In order to meet the target, it would have needed to have fallen by a further 100,000 to 2.3 million.[303]

118. Since then, the number of children in poverty has risen. In 2005–06, there was a reported rise in child poverty of 100,000 according to the Government's preferred measure *before* housing costs.[304] We expressed concern at this rise in child poverty in our Report on the 2007 Budget and called on the Government to state how it intended to meet the 2010–11 target to halve the number of children in poverty and where the resources would come from to meet that target.[305] The latest Household Below Average Income report was published by the Department for Work and Pensions on 10 June 2008. This showed that the number of children living in poverty rose by a further 100,000 in 2006–07 to 3.9 million after housing costs and 2.9 million before housing costs. As a consequence of these two successive rises, the number of children in poverty before housing costs is now 200,000 higher than it was in 2004–05.[306]

Meeting the 2010 target

119. The Treasury told us that the measures announced in the 2007 Budget, that year's Pre-Budget Report and this year's Budget which we referred to earlier would help lift a further 500,000 children out of poverty.[307] Mr Chote told us during our inquiry into the 2008 Budget that the measures in the 2008 Budget would move 200,000 to 250,000 children out of poverty, which would leave the Government around "450,000 short of the target". Mr Chote estimated that bridging this gap would require additional expenditure of around £2.8 billion for the Government to meet its 2010 target.[308] Save the Children told us that "following announcements in recent budgets, it is now estimated £3 billion will give the Government a 50:50 chance of meeting the goal".[309] The Chancellor of the Exchequer reaffirmed the Government's commitment to meeting its child poverty targets, telling us that "it is a very important target and I attach considerable importance to it".[310] The Chancellor of the Exchequer went on to tell us that "the battle to eradicate child poverty is not yet won; we have some way to go".[311]

120. We welcomed the measures in the 2008 Budget on child poverty in our Report on the 2008 Budget. We recommended that the Government clarify the targets that had been set relating to child poverty and report on performance against each of those targets in each financial year. Furthermore, we expressed concern that the Government "has yet to

303 IFS, *Poverty and inequality in Britain: 2006*, March 2006, p 33, Table 3.4

304 Ev 102

305 HC (2006–07) 389–I, para 48

306 Office for National Statistics, First Release, *Households Below Average Income Statistics*, June 2008

307 Ev 123; see paragraphs 24–26, 32, 35.

308 HC (2007–08) 430, paras 50–51

309 Ev 159

310 Q 157

311 Q 206

provide a clear explanation of the linkage between its target to halve child poverty by 2010–11 and the proposed deployment of resources to meet that target". We pressed the Government to "make it clear that the necessary resources to meet the 2010–11 target are available and that the Government is committed to deploying those resources directly to support low-income families".[312]

Methods of tackling child poverty

121. In *Ending child poverty: everybody's business,* which was published alongside the 2008 Budget, the Government reiterated its broad strategy for tackling child poverty:

> Recognising the multiple factors that cause child poverty, the Government's strategy is also broad-ranging, aiming to eradicate all the causes of child poverty now and in the future. The Government strongly believes that work is the most sustainable route out of poverty and supporting parents into work is at the heart of the Government's strategy to tackle child poverty. The Government is also committed to supporting parents in their parenting role and delivering excellent public services that improve children's lives in the short term and break cycles of deprivation in the long term. Key to the Government's approach to tackling child poverty is the principle of progressive universalism: delivering help for all families and more help for those who need it most, when they need it most.[313]

122. The Government's focus on increasing employment through active labour market policies, such as the New Deal, have been pursued alongside the introduction of measures such as the National Minimum Wage and Working Tax Credit to reward work and thus improve incentives for individuals to participate in the labour market. We discuss many of these policies in greater detail later in this Report.

123. Alongside the focus on moving people into employment, the Government has also improved financial and material support for families through the introduction of Child Tax Credit as well as through other changes to the tax and benefit system. We described all of the relevant measures in the 2007 and 2008 Budgets and the 2007 Pre-Budget Report in chapter 2 of this Report.[314] Save the Children summarised the broad thrust of Government policy in this area over the last few years, telling us that:

> recent Budgets and Pre-Budget Reports have seen significant investments in child poverty reduction. These have included rises in the Child Tax Credit and a multi-year commitment to raise the child element in line with average earnings, increases in Child Benefit particularly focussed at the eldest child, the nationwide roll-out of the In Work Credit, increases in the disregard with respect to child maintenance payments and Child Benefit and extension of the Working Tax Credit thresholds.[315]

312 HC (2007–08) 430, para 52

313 HM Treasury, Department for Work and Pensions, Department for Children, Schools and Families, *Ending child poverty: everybody's business,* March 2008, p 35, para 4.5

314 See paragraphs 24–26, 32, 35.

315 Ev 159

124. At the time of the 2008 Budget we asked Mr Chote whether the Government was more likely to meet its 2010–11 child poverty target through increasing employment levels or through transfer payments, such as tax credits and Child Benefit. At that stage, he viewed the remaining progress required as most likely to be achieved through the benefits system, stating that "it is either transfer payments or nothing at this stage". Mr Chote was sceptical about the contribution that increasing employment could make at this stage towards meeting the 2010–11 target:

> It does not make much difference on the timescale for 2010. If you were to achieve the Government's lone parent employment target it would probably cut the amount you needed to spend by about £200 million. That was the calculation we did a year or so ago. It shows basically that success on that front does not really get you very far in terms of the near-term target.[316]

On another occasion, Mr Chote outlined a possible trade-off in that the 2010–11 target could put pressure on the Government to go down the quickest cost-effective route of getting there, which would be to increase transfer payments, whereas focusing on the 2020 target might lead the Government to prioritise investment in longer term social investments but potentially at the cost of making it more likely that the 2010 target would be missed.[317]

Pensioner poverty

125. A number of submissions to our inquiry focussed on pensioner poverty and why tackling poverty amongst the pensioner population should be a Government priority. Barnardo's told us that the rationale for focussing Government support on pensioners was based on:

> pensioners being on fixed incomes and relying heavily on state benefits or other income which has been built up during their working lives. It is not realistic to expect those beyond state pension age to increase significantly the income they have to live on in retirement. Government support is therefore the only lever available to help increase the incomes of low-income pensioners.[318]

126. The Treasury stated that "over £11 billion more is being spent on pensioners in 2008–09 compared with 1997, with half the extra spending going on the poorest third". The Treasury went on say that "this has helped contribute to the 1.1 million pensioners who have been lifted out of relative poverty since 1997, and the 2.2 million pensioner households lifted out of absolute poverty".[319] Citizens Advice acknowledged that the Government had done much in this area with there being "a consistent fall in relative poverty amongst pensioners since 1997".[320] The latest Household Below Average Income

316 HC (2007–08) 430, para 51

317 Treasury Committee, First Report of Session 2007—08, *The 2007 Comprehensive Spending Review*, HC 55, para 62

318 Ev 145

319 Ev 123

320 Ev 70

report was published on 10 June 2008. This showed that the number of pensioners in poverty rose by 200,000 to 2.1 million after housing costs and by 300,000 to 2.6 million before housing costs in 2006–07. The IFS argued that "the actual increase is both statistically significant and unexpectedly large, especially as the Pension Credit guarantee is increased in line with average earnings".[321]

127. One of the Government's key policies to support pensioners was through the introduction of Pension Credit in 2003. Pension Credit is a means-tested benefit which, through the 'Guarantee' Credit element, provides a minimum guaranteed income for pensioners who choose to claim the benefit. The Treasury told us that "whilst the income support available to pensioners in 1997 was just £68.80, Pension Credit ensures that no pensioner has to live on less than £124 per week".[322] The increase in the Pension Credit to £124 a week for single pensioners in 2008–09 had been announced in the 2007 Pre-Budget Report and confirmed in the 2008 Budget.[323] Citizens Advice welcomed that rise, which they said "gave a welcome boost to the incomes of the poorest pensioners".[324]

128. Pension Credit is a means-tested benefit which claimants must apply for. However, a number of submissions to our inquiry focussed on low levels of take-up amongst pensioner households who were entitled to Pension Credit (as well as other means-tested benefits such as Housing Benefit and Council Tax Benefit) but were not claiming these benefits. The Treasury estimated that "the take-up rate for Pension Credit is between 70 and 78% when measured as a percentage of money being claimed, and between 60 and 69% when measured by caseload".[325] Since we concluded taking evidence, the Department for Work and Pensions has published new statistics on levels of take-up for Pension Credit. Worryingly, those figures indicate that in 2006–07 take-up fell, measured both by caseload and as a percentage of money claimed. The latest figures show that take-up in 2006–07 was between 59% and 67% by caseload, compared with between 60% and 69% in 2005–06 and that take-up was between 69% and 76% by expenditure in the more recent year, compared with between 70% and 78% in 2005–06.[326]

129. Prior to this latest announcement, Citizens Advice told us they believed that take-up of Pension Credit was very low with "estimates of the benefit unclaimed by people aged 60 and over … at least £2.4 billion and potentially as much as £4.2 billion per year".[327] Citizens Advice said that low take-up by pensioners was associated with the complexity of means-tested benefits, which leave many struggling as they fail to claim their full entitlement.[328] Ms Sally West, Policy Manager, Age Concern, agreed that take-up of Pension Credit was "a

321 Office for National Statistics, First Release, *Households Below Average Income Statistics*, June 2008; IFS press notice, "Poverty and inequality rise again as benefit payments lag inflation and incomes fastest for the rich", 10 June 2008

322 Ev 123

323 *Pre-Budget Report 2007*, p 86, para 5.58; *Budget 2008*, p 65, para 4.30

324 Ev 70

325 Ev 123

326 Department for Work and Pensions, *Income-related Benefits: Estimates of Take-up in 2006–07*, June 2008, p 29

327 Ev 70

328 Ev 72

huge problem”. She went on to outline some of the reasons why many pensioners are not taking-up Pension Credit:

> I think non take-up is a combination of a number of related factors. Firstly, there is awareness, although actually Pension Credit has got very high awareness. More important is the perceived eligibility, so people may have heard of Pension Credit but think that in their particular circumstances it will not apply. A lot of homeowners think they will not be entitled to benefits. The next barrier is the process. People do not want to give all their personal details, they do not want to go through the system of making claims, and among some people there is still this feeling that it is not quite right asking for help.[329]

130. As we noted earlier, the Government has sought to tackle the problem of poverty in pensioner households in part through the introduction of the payment of a non-means-tested Winter Fuel Allowance to pensioners, and through an additional one-off payment in 2008–09.[330] Age Concern told us that they welcomed the Government’s Budget announcement of “an additional one-off payment … ‘to help pensioners who are facing pressures such as higher energy bills’ and the £225 million package of assistance from the energy companies announced recently”.[331] Ms West explained that the Winter Fuel Allowance was very popular amongst pensioner households, largely because “it is simple to explain and it gets to people because in general you do not have to claim it. In that sense, I think people very much welcome it”.[332] However, Ms West went on to tell us that whilst people welcomed this year’s additional winter fuel payment, there was concern that “it is described as a one-off payment … so that leads to worries because people are thinking, ‘Maybe I’ll get an extra £50 this year, but then what?’.”[333] She said that the use of the Winter Fuel Allowance should not be seen as a long-term solution to tackling pensioner poverty:

> We would not see that in the long-term structure you should be having to rely on one-off payments and concessions. Our ideal world is that people have decent incomes through state and private pensions so they do not need to have a one-off bonus to help them meet their fuel bills, but we are quite a long way from that and it certainly does reduce the worry for a lot of people about fuel bills.[334]

131. The Government, as part of its longer-term pensions strategy, and as part of a wider package of reforms to the pensions system, has pledged to restore the earnings link for the Basic State Pension. A legal basis for regular up-rating of the Basic State Pension (by the better of prices or earnings) was introduced in 1974. However, the ‘best of’ legislation ended in 1979 and was replaced by a prices link.[335] In its 2006 Pensions White Paper: *Security in retirement: towards a new pensions system,* which followed the recommendation

329 Q 103

330 See paragraph 34.

331 Ev 99

332 Q 102

333 *Ibid.*

334 *Ibid.*

335 Department for Work and Pensions, *Security in retirement: towards a new pensions system*, May 2006, p 14

of the Pensions Commission chaired by Lord Turner of Ecchinswell, the Government stated that "during the next Parliament, we will re-link the uprating of the Basic State Pension to average earnings".[336] Citizens Advice told us that they welcomed the Government's intention to increase the state pension in line with earnings, although they urged the Government "to set a firm date for its implementation soon, to prevent the relative value of the pension falling further".[337]

Fuel poverty

Background

132. As discussed in the previous section on pensioner poverty, the Government has made a number of winter fuel payments and additional 'one-off' payments for pensioners. These payments represent a key element in the Government's strategy to tackle the problem of fuel poverty, which is a problem affecting many pensioner households. Age Concern confirmed to us that "older people are more at risk of fuel poverty than any other group, accounting for around 50% of households affected".[338]

133. The Government's Fuel Poverty Strategy, which was published in November 2001, set out targets to end fuel poverty in vulnerable households by 2010, where a vulnerable household was deemed to be one containing children, or those who were elderly, sick or disabled. The 2010 target was intended as a milestone towards eradicating fuel poverty in England by 2016. The 2016 target states that by 22 November 2016, as far as reasonably practicable, no person in England should have to live in fuel poverty. A household is said to be in fuel poverty if it needs to spend more than 10% of its income on fuel to maintain a satisfactory heating regime (usually 21°C for the main living area, and 18°C for other occupied rooms).[339]

134. The Scottish Fuel Poverty Statement, published in August 2002, sets out the Scottish Executive's overall objective for fuel poverty. This is to ensure that, as far as reasonably practicable, people are not living in fuel poverty in Scotland by November 2016.[340] The Welsh Assembly Government's target is that as far as reasonably practicable, no vulnerable household in Wales should be living in fuel poverty by 2010 and no household should be living in fuel poverty by 2018.[341] Northern Ireland has the same objectives as England.[342] The Government has stated that progress on this will be monitored by an inter-ministerial group and through the Fuel Poverty Strategy Annual Progress Report, which is published by the Department for Business, Enterprise and Regulatory Reform in conjunction with DEFRA. The Government has said that its primary tool in tackling fuel poverty over the

336 *Security in retirement: towards a new pensions system*, p 17

337 Ev 70

338 Ev 99

339 http://www.berr.gov.uk/energy/fuel-poverty/index.html

340 Scottish Executive, *Scottish Fuel Poverty Statement*, August 2002, p 30

341 Welsh Assembly Government, *Fuel Poverty Commitment for Wales*, March 2003, p 37

342 Northern Ireland Department for Social Development, *Ending fuel poverty: a strategy for Northern Ireland*, November 2004, p 29

period 2008–09 to 2010–11 will be DEFRA's Warm Front Scheme, which provides a package of heating and insulation measures to private sector households in receipt of certain benefits, and benefit entitlement checks to help maximise income.[343]

135. In our Report on the 2008 Budget we concluded that "it is important that the Government continues to tackle fuel poverty through a combination of targeted and universal measures and also stated:

> In view of the importance of measures announced in Budgets and Pre-Budget Reports to the progress of the targets to eradicate fuel poverty set by the Government itself and by the devolved administrations, we recommend that the Government report in Budgets and Pre-Budget Reports on the effect of any measures announced at that time on progress towards meeting fuel poverty targets.[344]

136. Ms West explained the wide variety of factors that influence levels of fuel poverty and why tackling fuel poverty was so difficult:

> fuel poverty is a combination of a range of factors. One of the difficulties of addressing it in Government is that it involves a lot of different government departments. It is about income levels, the cost of fuel, and also about conditions of housing and energy efficiency, so already you have got about four government departments, not including Treasury, that have an interest in that. That is the first thing we are arguing for, a very co-ordinated approach.[345]

Ms West expanded on some of the issues relating to housing and energy efficiency, telling us that:

> of course there are people in difficult to heat properties, so if you do not have access to gas mains in rural areas … or you have properties where it is difficult to insulate them, then even if you have got slightly higher income you may be having to pay a huge amount of your income in order to keep a good warmth within your property.[346]

Prospects for meeting the 2010 target

137. National Energy Action (NEA) told us that, "since 2004 progress in reducing fuel poverty has been halted and reversed … The 2007 Energy White Paper demonstrated how remote and unachievable [the] fuel poverty targets had become."[347] NEA estimated "that some 3 million households in England are currently in fuel poverty", with the total rising to 4.5 million across the United Kingdom.[348] Age Concern estimated that "the number of pensioner households living in fuel poverty in the United Kingdom has doubled in the last

343 *PSA Delivery Agreement 9*, p 16, para 3.33

344 HC (2007–08) 430, para 56

345 Q 100

346 Q 101

347 Ev 138

348 Ev 138, 140

four years, and now stands at 2.25 million".[349] NEA speculated that "significant further increases [in fuel poverty] may be imminent" given that energy prices had continued to rise over the last few months.[350] Ms West concurred that rising energy prices were an issue, telling us that "fuel prices have been going up substantially and are likely to continue to rise".[351] The Chancellor of the Exchequer told us that "fuel poverty fell steadily until about four years ago", before going on to explain the rise in fuel poverty since that date as taking place "mainly because of the oil prices which drove up electricity and gas prices".[352]

138. NEA noted that the Department for Business, Enterprise and Regulatory Reform had devised a model to assess the extent to which fuel poverty increased as energy prices rose, "with the model working on the assumption that a 1% real change in the price of both gas and electricity results in a further 40,000 households becoming fuel poor".[353]

Social tariffs and energy prices

139. In the 2008 Budget, the Government acknowledged that further action was needed to help vulnerable groups deal with rising energy prices. To this end, the Budget outlined plans to work together with energy supply companies. The Government welcomed "the steps the energy companies have already taken to help vulnerable customers cope with higher prices", but argued that more could be done.[354] The Government observed that "energy companies currently spend around £50 million a year on social tariffs", but went on to say that the Government would like to see that figure rising to at least £150 million a year. The Government stated that, acting with the companies and the energy regulator Ofgem, it would "draw up a plan for voluntary and statutory action to achieve that".[355] Since the 2008 Budget, the Government has announced that it had secured a commitment from the energy companies to provide an extra £225 million in social assistance by increasing their investment to £150 million per year by 2011. The Government estimated that this initiative could lift around 100,000 households out of fuel poverty.[356]

140. On 30 May the Government announced further measures to help tackle fuel poverty including, crucially, seeking changes in legislation to allow data-sharing with energy companies so that assistance could be targeted effectively on low-income households suffering from fuel poverty.[357] The Chancellor of the Exchequer explained how Government was working together with the power companies to try and tackle fuel poverty:

349 Ev 99

350 Ev 139

351 Q 101

352 Qq 169–170

353 Ev 139

354 *Budget 2008*, p 66, para 4.34

355 *Ibid.*

356 Department for Business, Enterprise and Regulatory Reform press release, 11 April 2008, "100,000 households could be lifted out of fuel poverty by an extra £225 million to help with rising fuel bills"

357 Department for Business, Enterprise and Regulatory Reform press release, 30 May 2008, "Help with fuel bills for the poorest consumers"

> In relation to the power companies, there are two things I would point to. One is general help and of necessity this is medium-term, the obligation on power companies to do more to help their customers reduce their bills by insulating their homes and reducing their energy requirement. Also, I think the steps we have agreed with the energy companies in relation to the premium that poor people on low incomes have to pay if they are paying through a prepayment meter, for example, but also the measures that were announced by the DWP last week. They are not the only things we have done, they are part of a wider programme of making it easier to identify to people in the power companies people who are at risk of falling into fuel poverty. At the moment we have that data, the DWP has that data, but it is not possible to make that available. I think that is something that is worth looking at.[358]

141. NEA thought that the sums of money that the energy companies were preparing to spend on social tariffs were "totally inadequate" in the context of the estimated 4.5 million households suffering from fuel poverty and was, "proportionately, less than some suppliers currently spend on discounted social tariffs for their disadvantaged customers".[359] The NEA saw it as

> a failure on the part of Government that it invites commercial companies to adopt a major role in pursuit of social welfare objectives and to determine, at their own discretion, the form and extent of assistance to vulnerable households; whilst energy suppliers may be a vehicle to deliver social policy they clearly cannot be the driver. NEA believes that a mandatory social tariff, prescribed by Government, and available in a consistent form to eligible households based on consistent criteria is the most rational approach to unaffordable energy costs.[360]

Age Concern reiterated these concerns, arguing that "mandatory social tariffs offering the lowest market rate should be made compulsory through the Energy Bill currently before Parliament".[361]

In-work poverty and making work pay

Overview

142. The announcement of the abolition of the starting rate of income tax as well as subsequent submissions to our inquiry have highlighted concerns about the extent of low pay and in-work poverty and the link between the two.

143. The IPPR told us that, in April 2006, over five million employees—around 22% of the workforce—were paid less than £6.67 an hour, equivalent to around £12,500 for a year based on a full-time working week and 60% of full-time median earnings.[362] The IPPR

358 Q 161

359 Ev 140

360 *Ibid.*

361 Ev 99

362 Ev 114

went on to say that "half of all poor children live in a working household, up from two-fifths a decade ago" and that the "incidence of low pay is a key factor underpinning the high rates of poverty and inequality".[363] The IPPR acknowledged that the relationship between low pay and poverty was complex, "given that the former relates to individuals and the latter to households" (meaning, for example, that a low-paid worker could be part of a household where the income of other members of the household lifted the household above the poverty line).[364] The NPI said that "the link between low paid workers and low income households is weak, with only 16% of low paid workers in a recent study belonging to households with incomes below the official poverty line".[365] However, despite the fact that many low-paid workers are not living in households experiencing poverty, it appears that a person is at greater risk of poverty if that person is low-paid. The IPPR told us that their own research showed that "the risk of being poor was 18 times higher for low-paid compared to non-low paid workers (7.2% compared to 0.4%)".[366]

In-work poverty among those with dependent children

144. As discussed earlier in this chapter, despite the fact that the Government has moved 500,000 children out of poverty since 1998–99, there are still 2.9 million children living in poverty. Of these 2.9 million children, around half are in families where someone works.[367] The IPPR stated that its own "research highlighted that half of all poor children live in a working household, up from two fifths a decade ago".[368] The IPPR went on to say that:

> While employment has risen and worklessness reduced, too many families have exchanged poverty out of work for poverty in work—better off than on benefits, but not enough to raise them above the poverty line. Nearly 80% of all working poor families with children are couples, the majority of whom have only one earner.[369]

145. The NPI pointed out that the number of children "in in-work poverty for the most recent three years also happens to be the average for both the three years immediately prior to the start of the Government's anti poverty programme and the whole of the period since the start of the 1990s", concluding that "there has been no sustained reduction whatsoever in in-work child poverty since the end of Lady Thatcher's premiership".[370]

146. The fact that 1.4 million children live in families where at least one parent works, but which has not provided a route out of poverty, appears to cast doubt upon the Government's message that work is the most sustainable route out of poverty and that supporting parents into work is at the heart of the Government's strategy to tackle child poverty. It also illustrates that the reduction in child poverty is concentrated amongst

363 Ev 115

364 *Ibid.*

365 Ev 117

366 Ev 115

367 IFS, *Poverty and inequality in the UK: 2008*, June 2008, p 67; *Ending child poverty: everybody's business*, p 15

368 Ev 115

369 *Ibid.*

370 Ev 118

workless families with 1.4 million poor children living in workless households—a reduction of 2 million from the total 10 years earlier. Ms Carey Oppenheim, Co-Director of the IPPR, told us that, "to some extent, probably what people are doing is exchanging more severe poverty out-of-work for less severe poverty in-work and that is probably better, but we definitely think people should be able to get out of poverty once they are in paid work".[371] However, despite the large number of children in poverty where at least one parent is working, it is important to remember that the risk of poverty for children in working families is relatively low at 14% compared to a 58% risk of poverty for children living in families where no one works.[372]

In-work poverty among those without dependent children

147. A number of submissions highlighted the growth of in-work poverty among those without dependent children, an issue which, until recently, had received relatively little attention from policy-makers and the media. The NPI told us that "the furore over the 10p should also alert us to the fact that in-work poverty is by no means confined to those with children … the number of adults without dependent children who are in in-work poverty has risen over a decade from 1 to more than 1.5 million."[373] The NPI went on to tell us that "these working people, without dependent children yet in poverty, are now almost as numerous as working parents with dependent children in poverty".[374]

Marginal deduction rates

148. The Treasury defines the poverty trap as occurring "when those in work have limited incentives to move up the earnings ladder because it may leave them little better off".[375] Marginal deduction rates are used to measure how far people's incentives to increase their income are being reduced. For instance, a marginal deduction rate of 70% means that, for every one pound of additional gross income, 70 pence of that extra pound is taken away, either by taxes or a reduction in benefits.

149. The Government has stated that "as a result of the introduction of tax credits, in combination with other reforms, individuals have improved incentives to progress in work".[376] The Treasury told us that "to help make work pay, the Government has also reduced the number of families facing the highest marginal deduction rates (above 70%) by over half a million since 1997".[377] As can be seen from Table 4, the Government has sharply reduced the number of working families with the highest marginal deduction rates of over 90%, from 130,000 before the 1998 Budget to 25,000.

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371 Q 106

372 *Ending child poverty: everybody's business*, pp 15–17

373 Ev 118

374 *Ibid.*

375 *Budget 2008,* p 62, para 4.15

376 *Tax credits: improving delivery and choice*, p 17, para 3.7

377 Ev 122

Table 4: Number of working heads of non-pensioner families with high marginal deduction rates: changes since 1997

Marginal deduction rate	Before Budget 1998	2008–09
Over 100%	5,000	0
Over 90%	130,000	25,000
Over 80%	300,000	150,000
Over 70%	740,000	185,000
Over 60%	760,000	1,860,000

Source: Ev 126. Numbers given relate to marginal deduction rates for working heads of non-pensioner families in receipt of income-related benefits or tax credits where at least one person works 16 hours or more a week, and the head of the family is not receiving pensioner or disability premia: see Budget 2008*, p 62, Table 4.2.*

However, Table 4 also shows that the number of people caught by a marginal deduction rate between 60% and 70% has risen sharply, from 20,000 before the 1998 Budget to 1,675,000. We asked the Treasury about the large increase in the number of families facing marginal deduction rates of between 60% and 70% during our inquiry into the 2008 Budget. At that stage, Treasury officials told us that "the main reason for that is … as a result of the 2007 Budget measure that introduced extra help through tax credits from 2008. That brought more people into tax credits, the result being that more people then faced higher marginal deduction rates."[378] The Government has argued that "looking at marginal deduction rates alone gives an incomplete picture of work incentives". In *Tax credits: improving delivery and choice*, it said that this was because:

> They ignore some key features of the tax and benefit system, such as the effect of the tax credits income disregard, which allows people to increase their income during the year without having their tax credits withdrawn in the current year. In addition, they only look at marginal changes in income whereas, in reality, changes in income tend to be larger and can move people off the tax credits taper or entitle them to additional support (through, for example, the 30 hours element of the Working Tax Credit). This means that the choice for individuals tends to be not about earning at the marginal rate but about much larger movements in income.[379]

150. The NPI noted that "tax credits are the Government's tool of choice when it comes to poverty",[380] before expressing concern that tax credits were increasing the marginal deduction rates faced by many lower-income families.[381] Mr Kenway said that "the longer term objective should be directed at ending the situation we have at the minute where the marginal rates of deduction … are basically 70% for anybody receiving a tax credit above the minimum".[382] The NPI argued that:

378 HC (2007–08) 430, para 59

379 *Tax credits: improving delivery and choice*, p 17, para 3.9

380 Ev 119

381 Ev 120

382 Q 75

> It cannot be said loudly enough that such high 'tax' rates (for that in effect is what they are) are quite absurd: the very households who would most benefit from even small amounts of extra money face the highest tax rates which reduce their net gain from extra earnings to a pittance. Substantial reductions in the marginal rates of 'tax' faced by low income working households are an essential part of the anti-poverty strategy going forward … [and] that a programme of 'cutting taxes at the bottom' is now required to help reduce in-work poverty. Increasing the income tax personal allowance is an integral part of this; although other measures are needed too.[383]

The IPPR also focussed on weak work incentives and, in particular, on what they described as the 'pinch points' in the benefits and tax credits system, which create the weakest work incentives and the greatest financial insecurity. The IPPR noted that "Housing Benefit and Council Tax Benefit are central to the problem of high marginal tax rates".[384] We discuss Housing and Council Tax Benefit further in chapter 7.[385]

Conclusions

151. **Further measures arising from the removal of the 10 pence rate of income tax must be considered in the context of the wider objectives that the Government is seeking to achieve through the tax and benefits system. The case for action to meet the Government's target to halve child poverty by 2010–11 is more pressing than ever given the further rise in child poverty by 100,000 children in 2006–07 to 2.9 million before housing costs. Pensioner poverty rose significantly in 2006–07, by 300,000 to 2.6 million before housing costs, reversing the welcome downward trend since 1997. Progress on fuel poverty is being reversed by rapidly rising energy prices. The recent announcements on a social tariff, data-sharing and pre-payment meter charges are welcome, but much more needs to be done. The Government should consider urgently the case for extending the social tariff for all domestic energy suppliers, such as suppliers of liquified petroleum gas, heating oil and bottled gas, including through further legislation. The advances made in tackling poverty among those out of work in the last decade has not been matched by comparable progress in tackling poverty among those in work. We note that the total cost of the 13 May measures was exactly the amount required to meet the Government's child poverty target. In responding to the concerns arising from the removal of the 10 pence rate of income tax, the Chancellor of the Exchequer has been forced to reconsider the balance between a complex system of tax credits and a simpler, more transparent approach. Looking ahead, the benefits of simplicity, transparency and of reducing disincentives to work should be considered alongside the Government's other objectives.**

383 Ev 120

384 Ev 115

385 See paragraphs 213–214.

6 Lessons for budgetary processes

The purpose of this chapter

152. So far in this Report we have been concerned largely with the substantive effect of Budget measures and of subsequent policy options, as well as with the broader context in which future decisions will be taken. In this chapter, we draw conclusions and make recommendations about the lessons to be learned from the handling of the removal of the 10 pence starting rate of income tax, principally for the Government itself, but also for others concerned with the authorisation and scrutiny of policy decisions in this area, including the House of Commons itself.

Information available to Ministers

153. Late in April this year, Mr Nicholas Macpherson, Permanent Secretary to the Treasury, told the Committee of Public Accounts that "a thorough distributional analysis was done" regarding the impact of the abolition of the 10 pence rate of income tax and that "Ministers took decisions on the basis of that analysis".[386] In evidence to us, the Chancellor of the Exchequer confirmed that Budget decisions were made after considering their distributional effects and that, when the original decision had been taken in the 2007 Budget, "it was recognised … that there were people who were losing out".[387]

154. There is other evidence to suggest that the Treasury was aware from the outset of the full distributional effects of the 2007 Budget decisions. As we have noted before, a Treasury official told us on 28 March 2007 that the estimate by the IFS given to us two days earlier that 5.3 million families would lose was "in the right ball-park".[388] However, a series of announcements by Ministers in the House of Commons since then have suggested either that Ministers were not awake to the full impact or else remained in denial about it.[389] **We noted earlier that the use of the household as a unit of measurement does not necessarily correspond to social realities, in that a household may not equate with a single financial unit with a shared household budget. It is thus important that Budget proposals and decisions are made with the fullest range of information about different forms of distributional analysis.**

Transparency and the provision of information to others

155. The range and quality of information available to Ministers in advance of a decision being announced is also related to the issue of the information provided to others. The Code for Fiscal Stability, which was published in November 1998 and which sets out what the Government sees as the principles of fiscal management, states:

386 Committee of Public Accounts, Uncorrected transcript of Oral evidence, *Improving Finance resource Management to deliver better public services*, 28 April 2008, Q 137

387 Qq 188–189

388 See paragraph 29.

389 See paragraphs 28–30.

> The principle of transparency means that the Government shall publish sufficient information to allow the public to scrutinise the conduct of fiscal policy and the state of the public finances.[390]

156. During our inquiry into the 2007 Budget, we were frustrated by the apparent reluctance of the Treasury to confirm the precise effect of the abolition of the starting rate of income tax in terms of winners and losers. A Treasury official appeared to endorse the analysis by the IFS, while the Chancellor of the Exchequer drew attention to the inadequacies of that analysis.[391] In our Report on the 2007 Budget, we concluded that

> An important part of any change to the personal taxation regime must be that both winners and losers can identify, with ease, how they are affected by the changes stated within a Budget package. We recommend that, in future, this information be provided within the Red Book.[392]

That recommendation was supported during the current inquiry by Citizens Advice.[393] In its response in June 2007, the Government said:

> The reforms announced in Budget 2007 included eight separate measures designed to simplify the system, help pensioners, tackle child poverty and make work pay. The overall effect on a household will depend on the interactions between the different elements. So whether, or by how much, one might gain from these changes will depend on both individual and household characteristics. Therefore in this case it was not feasible in the space available to set out comprehensive tables of the effects of all the measures. However, HMRC will, as usual, produce their specimen tables following Budget 2008 once all the tax, national insurance other parameters have been finalised. In addition, HM Treasury has provided detailed answers to Parliamentary Questions of the impact in specific circumstances that the Committee might find helpful.[394]

This Government response failed to address the need we had identified for information that was available at the time a policy was announced, but was justified in highlighting the fact that individual tax effects were dependent on wider household circumstances.

157. In our Report on 2007 Budget we had also highlighted the need for the Government to provide a broader analysis of its measures, citing the example of the complex interaction of different policy initiatives relating to child poverty:

> We have noted the Government's reference to many different strands of the personal tax, benefits and tax credits system when describing its efforts to combat child poverty. On top of this, there is also a need to consider the efforts of other

390 HM Treasury, *The Code for Fiscal Stability*, November 1998, para 4

391 See paragraph 29.

392 HC (2006–07) 389–I, para 41

393 Q 66

394 Treasury Committee, Fifth Special Report of Session 2006–07, *The 2007 Budget: Government Response to the Committee's Fifth Report of Session 2006–07*, HC 696, p 7

departments, such as the Department for Work and Pensions. It is appropriate that the Government use every means at its disposal when tackling such a difficult but important issue. But, this also raises issues of transparency and accountability. We recommend that whenever the Government reports on complicated, multi-faceted responses to policy issues, such as child poverty, it should attempt to draw together all the analysis on all relevant policy instruments in the appropriate Budget or related document, so that it is transparent what the different policies are intended to achieve, at what cost, and how the whole package of policies will interact and achieve their purpose.[395]

158. At present, the Government is required by its own guidance to prepare and issue Impact Assessments for all policy proposals, including those within Budgets. These are centred on impacts on the public, private and third sectors, but also include as appropriate a competition assessment, a small firms impact test, an assessment on implications for legal aid, a sustainable development assessment, a carbon assessment and other environmental impacts assessment and a health impact assessment, and also address issues relating to disability equality, gender equality, human rights and "rural proofing". These impact assessments are prepared separately for each Budget measure.[396] They thus deal with individual measures, not their interaction and overall impact. Impact Assessments are also not concerned directly with household or household income.

159. **The quality and quantity of information about Government decisions, including Budget decisions, has improved in recent years, in part through the provision of Impact Assessments. However, the current documents do not take sufficient account of the interaction of Budget measures with each other and with other policy decisions. This Committee has repeatedly recommended that Ministers include in the Red Book a table showing the winners and losers from the proposed personal tax and benefit changes. We recommend that the Government publish a Household Impact Assessment alongside future Budgets and Pre-Budget Reports. This would analyse the impact on individual, family and household finances of Budget measures and other changes to the welfare system, having regard to other developments such as changes to the National Minimum Wage. We further recommend that the Household Impact Assessment provide distinct analyses for each future financial year to which Budget measures relate.**

Budget decision-making and the role of the Pre-Budget Report

160. There has been a long-standing practice that the process of Budget-making is shrouded in secrecy. A difference in approach between tax policy-making and policy-making more generally is justified because certain decisions in the field of taxation, in the words of the Code for Fiscal Stability, "carry the risk of forestalling activity by existing or prospective taxpayers or could lead to significant temporary distortions in taxpayer and

395 HC (2006–07) 389–I, para 51

396 Cabinet Office, *Impact Assessment Guidance*; HM Treasury and HM Revenue & Customs, *Impact Assessments*, March 2008

marker behaviour”.[397] The current Government has sought to broaden the range of information provided alongside Budgets. It has introduced the Pre-Budget Report into the budgetary calendar, an event which take place at least three months prior to the Budget and which is intended to be ‘consultative in nature’ and to ‘include, so far as reasonably practicable, proposals for any significant changes in fiscal policy under consideration for introduction in the Budget’.[398] However, there remains scope for improvement.

161. In our Report on the 2006 Pre-Budget Report, we argued that the Government had failed to develop the Pre-Budget Report as an effective tool for consultation on substantive fiscal measures that might be included in the ensuing Budget.[399] In our Report on the following year’s Pre-Budget Report, we stated that we continued “to support the principle set out in the Code for Fiscal Stability, that the Pre-Budget Report should be consultative in nature, and should include, so far as reasonably practicable, proposals for any significant changes in fiscal policy under consideration for introduction in the Budget”.[400] Our calls for a more consistent use of the Pre-Budget Report for consultation about revenue-raising plans have recently been supported by the House of Commons Liaison Committee.[401]

162. The removal of the starting rate of income tax was announced well in advance—on 21 March 2007 for implementation on 6 April 2008—but it was announced in the form of a final decision in the long tradition of Budget measures rather than as a proposal subject to consultation in a Pre-Budget Report. The form and timing of the announcement has had several adverse consequences. First, it was perceived as a *fait accompli* from the moment of the decision, closing off avenues for consultation.[402] Second, by announcing the decision so far in advance, the Government was politically committed to implementing a measure in April 2008 well before the precise economic circumstances at the time of implementation, which we discussed earlier,[403] could have been apparent.

163. Since the Government became committed to further tax changes to undo some of the damage done by the removal of the starting rate of income tax, it has placed emphasis on the 2008 Pre-Budget Report, as opposed to the 2009 Budget, as the major policy statement in which the Government will seek to address concerns.[404] **We welcome the emphasis by the Government on the 2008 Pre-Budget Report, but the Government should not simply respond to a short-term political problem by turning the 2008 Pre-Budget Report into an early Budget. Instead, the Government must re-establish the consultative nature of the Pre-Budget Report. For personal tax decisions, the sudden and final nature of Budget decisions has been less about the need to prevent forestalling activity than it has been about the perceived benefit of seeming to pull rabbits from the**

397 The Code for Fiscal Stability, para 16

398 *Ibid.*, paras 15–16

399 Treasury Committee, Second Report of Session 2006–07, *The 2006 Pre-Budget Report*, , HC 115, para 95

400 HC (2007–08) 54–I, para 76

401 Liaison Committee, Second Report of Session 2007–08, *Parliament and Government Finance: Recreating Financial Scrutiny*, HC 426, para 55

402 Ev 155

403 See paragraph 67.

404 Ev 121; HC Deb, 13 May 2008, col 1202; Q 133

hat. Recent experiences suggest that such short-term benefits are outweighed by the longer term benefits from proper consultation.

164. **We do not envisage consultation being confined to individual tax measures. Rather, the Government should seek to create the optimal conditions for constructive consultation by being clear about the policy objectives it is seeking to achieve as well as the means being proposed to meet those objectives. In particular, we wish the Government to use the opportunity of the 2008 Pre-Budget Report to set out clearly its views on the policy objectives which underpin its approach to personal taxation.**

The role of scrutiny

165. The controversy over the removal of the 10 pence tax rate has highlighted the importance of effective parliamentary scrutiny of tax measures. To some extent, the rapid change in Government policy since the time of the 2008 Budget demonstrates a strength of the House of Commons: the Government has not been able to take for granted success in the passage of the Finance Bill as originally proposed and this has served to concentrate its collective mind. However, the weaknesses of the House of Commons in its scrutiny of tax measures, which have been noted in several recent studies,[405] have also arguably been highlighted by recent events.

166. Although we played a role in illuminating the effects of the removal of the 10 pence rate of income tax, it is now evident to us that our Report on the 2007 Budget accepted too readily the then Chancellor of the Exchequer's emphasis on the potential for increased take-up of Working Tax Credit to alleviate the problems caused by the removal of the starting rate of income tax and that we could have done more to highlight the information we received about the losers from the measures in that Budget. **We intend to re-examine the way we scrutinise tax proposals in Pre-Budget Reports and tax measures in Budgets and propose changes to our own working methods. We expect our own re-examination to form part of a wider consideration by the House of Commons and its committees of ways in which the scrutiny of tax measures can be improved and strengthened.**

405 See, for example, Hansard Society, *The Fiscal Maze: Parliament, Government and Public Money*, July 2006, and HC (2007–08) 426