A Impact of tax and welfare changes on households

Transparent policy making

A.1 The document, *Tax policy making: a new approach*, published at Budget, sets out the Government's commitment to improving tax policy making. It is vital that all policy decisions are properly scrutinised. This requires greater transparency about the impact of changes and this chapter is intended to help interested parties understand the impact on households of tax and welfare proposals. For future fiscal events the Government will consider how best to present the impact of changes on households consistent with these aims of transparency.

Impact of direct tax and tax credit changes

A.2 This section sets out the impact on individuals of the personal tax changes announced in this Budget; and on families of the tax credit changes announced in this Budget. The examples in the tables below are necessarily simplified, however they serve as a guide to changes in tax paid and tax credits received at different income levels.

A.3 The amounts set out in the tables below are based on the OBR's latest independent projections for CPI and RPI and the actual amounts will vary depending on actual levels of CPI and RPI over the relevant periods.

Income tax and National Insurance Contributions

A.4 Table A1 below shows income tax and National Insurance Contributions (NICs) paid for individuals under the age of 65 at different income levels. It shows the amount currently being paid; the amount that would have been paid in 2011-12 under the plans this Government has inherited; and the amount that will be paid in 2011-12 and 2012-13 following the changes announced in this Budget.

Table A1: Illustrative examples of income tax and National Insurance paid per year, by income level

Gross Income (£)	2010-11 (£)	2011-12 at March 2010 Budget (£)	2011-12 after this Budget (£)	2012-13 after this Budget (£)
10,000	1,175	1,010	840	760
20,000	4,275	4,210	4,040	3,960
30,000	7,375	7,410	7,240	7,160
40,000	10,475	10,610	10,440	10,360
50,000	14,190	14,410	14,405	14,315
75,000	24,440	24,910	24,905	24,815
100,000	34,690	35,410	35,405	35,315
150,000	57,780	59,060	59,395	59,410

Calculations based on individual aged 65 or under paying employee NICs (not contracted out). Gross income refers to pay only before the personal allowance is deducted (i.e. all gross income is subject to income tax and class 1 NICs). Calculations assume no other allowances or deductions. NICs calculations on an annual basis using equivalent annual thresholds.

Source: HM Revenue and Customs

Tax credits

A.5 Table A2 below shows the changes to tax credits received for a family with one child over the age of one and no childcare costs at different levels of family income. It shows the amount of tax credits they are currently entitled to receive; the amount they would have received in 2011-12 under the plans this Government has inherited; and the amount they will receive in 2011-12 and 2012-13 following the changes announced in this Budget.

Table A2: Illustrative examples of a family's tax credit entitlement per year, by income levels

Family Income (£)	2010-11 (£)	2011-12 at March 2010 Budget (£)	2011-12 after this Budget (£)	2012-13 after this Budget (£)
0	2,850	2,945	3,065	3,200
5,000[1]	6,660	6,865	6,990	7,235
10,000	6,060	6,285	6,340	6,610
15,000	4,110	4,335	4,290	4,560
20,000	2,160	2,385	2,240	2,510
25,000	545	545	545	460
30,000	545	545	545	–
40,000	545	545	545	–
50,000	545	545	–	–

1 Assumes not entitled to 30 hour element
Calculations are based on a family with one child over the age of one, with no entitlement to baby, childcare or disability elements
2 Families receiving tax credits are most likely to have one child.
Source: HM Revenue and Customs

The combined impact of changes on households

A.6 There are a number of different ways of assessing the combined impacts of tax, tax credits and benefit changes on households. For example, impacts can be shown in absolute cash terms or as a percentage of income. The advantage of the former approach is that it can show how much of the change is borne along the income distribution; the advantage of the latter approach is that it shows how the change will impact on households relative to their overall income or expenditure.

A.7 It is also possible to show impacts across the income or expenditure distribution. Traditionally analysis of tax and benefit changes on households has been measured against the income distribution as in Charts A1 and A2 below. This is particularly relevant when assessing the impacts of changes in direct taxes, tax credits and benefits which change the net income of a household; or for analysis of the short-term impacts of a policy.

A.8 However, the Office for National Statistics and others suggest that analysis of the income distribution can be potentially misleading when analysing the impact of expenditure taxes. Among the reasons for this is that for some households, predominantly in the bottom decile, expenditure exceeds current income.[1] This could be because some households – typically those containing students, self-employed and unemployed individuals – experience temporary periods of low income and fund their expenditure from savings or borrowing.[2] Because such households are smoothing their lifetime consumption, expenditure may be a better indicator of their standard of living.[3]

A.9 There are advantages and disadvantages to each of these approaches and for transparency the impact on households using all these approaches are included in this chapter.

Methodology

A.10 The impacts shown in this section are simulated using HM Treasury's tax and benefit model and assume 100 per cent take up of tax credits and benefits. The policies that can be modelled account for around two-thirds of benefits and tax credits changes and the majority of direct and indirect tax announcements.[4] A full list of the measures that can be modelled together with a methodological explanation is set out in the data sources document.[5] This does not include the impact of plans this Government has inherited to restrict the generosity of pensions tax relief.

A.11 Income and expenditure deciles divide households into 10 equally sized groups. As households with more adults and children require higher levels of household income and expenditure to achieve the same standard of living, an internationally recognised process called equivalisation has been used to ensure households are compared on an equal basis.[6] The income and expenditure levels on the horizontal axis of this chart shows the lower income or expenditure bound for a couple household with no children to be in the relevant income or expenditure decile. These income or expenditure levels will vary for different household types.

A.12 The impact of measures is shown for April 2012 given the staged implementation of the tax credit changes. It shows the impact of changes in comparison to what the tax and benefit system looks like currently in the absence of changes occuring in 2012.

[1] *The effects of taxes and benefits on household income*, 2008-09, Office for National Statistics, June 2010.
[2] *An expenditure based analysis of the redistribution of household income*, Office for National Statistics, March 2010.
[3] *The distributional effect of the Pre-Budget Report 2008*, Institute for Fiscal Studies, December 2008.
[4] This includes the impact of CPI indexation of tax credits and benefits; changes to tax credit rates and thresholds; and the abolition of some tax credit elements.
[5] Not all policy announcements can be modelled due to data constraints.
[6] Equivalisation is explained in more detail in the data sources document.

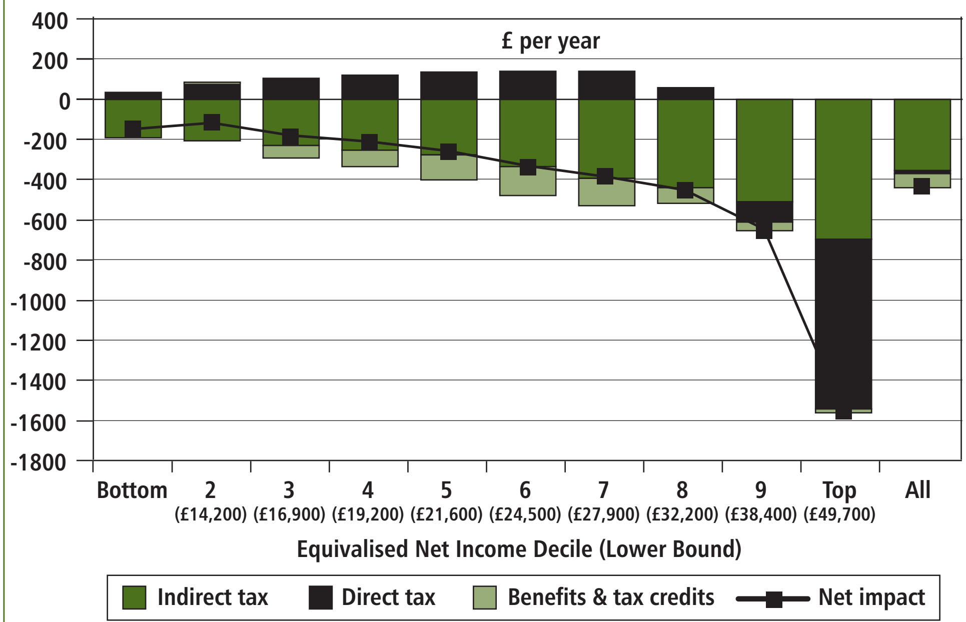
Analysis by income distribution

A.13 The impact of direct tax, indirect tax, and benefit and tax credit changes as an absolute amount by income decile is shown in Chart A1. The top decile see the largest absolute losses, losing more than twice as much as the ninth decile, and more than ten times as much as the bottom decile. On average the first three deciles experience the lowest losses.

A.14 All but the top two deciles will see gains from direct taxes. For the top deciles, gains from the increase from the personal allowance will be offset by the NICs rise announced at the 2009 Pre-Budget Report and the March 2010 Budget. Households in the bottom two deciles are on average gainers from modelled changes to benefits and tax credits.

A.15 The increase in the standard rate of VAT is the most significant change to indirect taxes. The analysis assumes that indirect tax changes are passed to the consumer in full, although in practice some retailers may decide to absorb the increase rather than increase prices for consumers.[7]

Chart A1: Impact of all measures in cash terms (£ per year) by income distribution (2012-13)

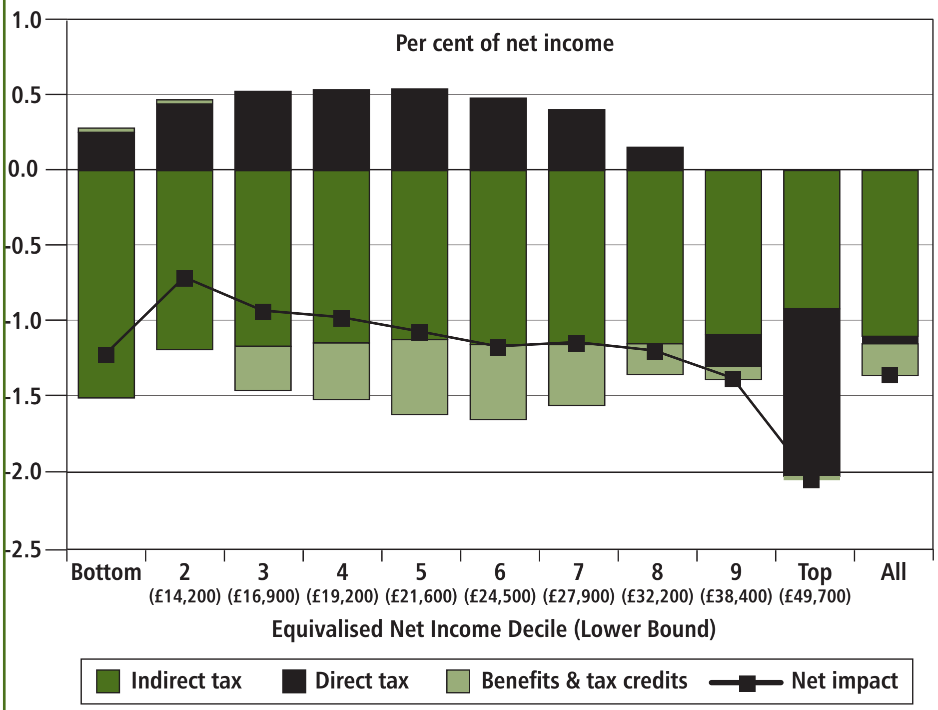


Source: HM Treasury tax and benefit micro-simulation model.

A.16 Chart A2 shows the overall impact as a per cent of net income to be more evenly spread across the income distribution. Impacts on households from VAT account for around 1.0 per cent of net income, although this is smaller on average for the top 10 per cent of households, and greatest for the bottom 10 per cent of households. However, as discussed above the impact of indirect taxes may be better illustrated by Charts A3 and A4 which show the impact of indirect taxes by expenditure decile. Households in the bottom income decile are spread across the expenditure distribution, though concentrated in the bottom three expenditure deciles. This reflects the fact that some households may be funding expenditure through savings or borrowing.

[7] In contrast, the OBR's economic forecast assumes two-thirds pass-through of VAT to consumers initially (with further adjustments in the following year) which would reduce the immediate impact on households. Further, the OBR have assumed that the economic impact will dissipate over the forecast period due to wider economic effects (see Annex C for further details).

Chart A2: Impact of all measures as a per cent of net income by income distribution (2012-13)

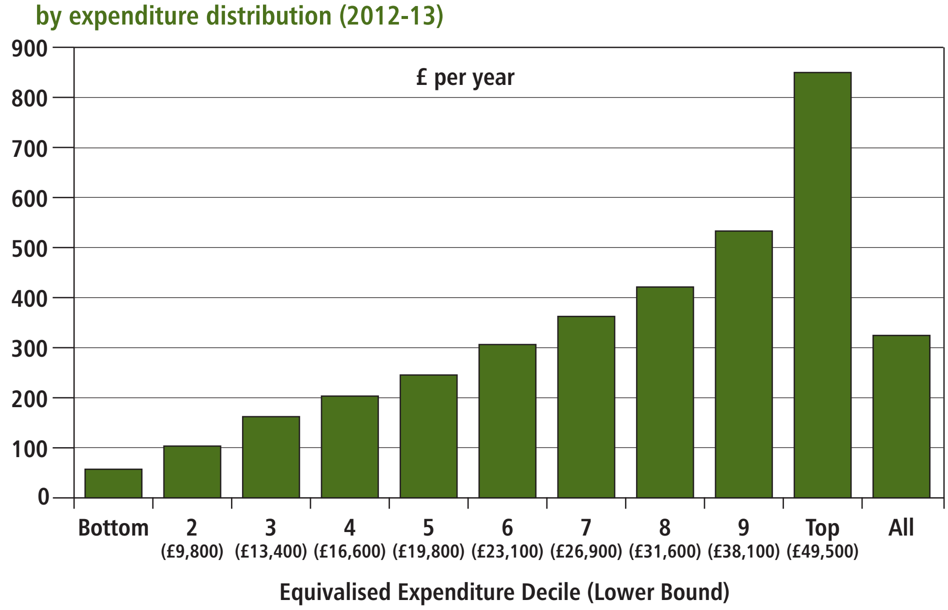


Source: HM Treasury tax and benefit micro-simulation model.

Analysis of expenditure distribution

A.17 The impact of the changes to VAT and duties by expenditure distribution is shown in Chart A3. The changes in VAT and duty rates are progressive on this basis. This is in part because goods not charged at the standard rate of VAT, such as food, domestic fuel and children's clothes, account for a higher proportion of expenditure for lower spending households. Chart A3 shows that the top expenditure decile will lose almost 15 times more, in absolute terms, than the bottom expenditure decile from changes in indirect taxes.

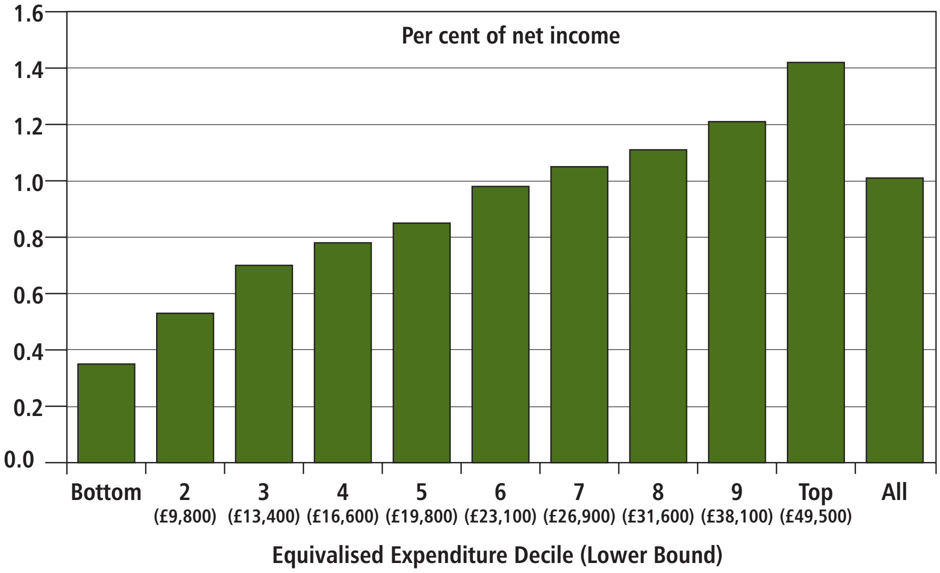
Chart A3: Additional tax due to indirect tax Budget changes in cash terms (£) by expenditure distribution (2012-13)



Source: HM Treasury tax and benefit micro-simulation model.

A.18 Chart A4 confirms the pattern seen in Chart A3 but as a percentage of income. This is in order to demonstrate the impact on household income.

Chart A4: Impact of indirect tax Budget changes as a per cent of net income by expenditure distribution (2012-13)



Source: HM Treasury tax and benefit micro-simulation model.

Marginal deduction rates

A.19 Marginal deduction rates (MDRs) show how much of each additional pound of earnings is lost due to taxes and the withdrawal of benefits or tax credits. To better illustrate how direct tax, tax credits and benefit changes affect MDRs, the following table shows the position in 2010-11, the impact in 2011-12 of the plans this Government has inherited, and the further impact in 2011-12 of measures included in this Budget for specific families. Increases in the number of families in each category in 2011-12 at the March 2010 Budget are due to the 1 per cent increase to NICs. There are slight changes to each category after this Budget as a result to an increase in the tax credit taper. Families facing withdrawal of tax credits and paying income tax and NICs see their MDRs rise in 2011-12 from 70 to 71 per cent as a result of the NICs increase; and from 71 to 73 per cent as a result of the changes to the tax credit taper. As part of a wider look at how impacts on households are modelled HM Treasury will be undertaking a review of the methodology used to produce this table and future estimates may change.

Table A3: The effect of Government reforms on high marginal deduction rates

Marginal Deduction Rates[1]	2010-11	2011-12 at March 2010 Budget	2011-12 after this Budget
Over 100 per cent	0	0	0
Over 90 per cent	70,000	110,000	130,000
Over 80 per cent	270,000	335,000	330,000
Over 70 per cent	330,000	1,680,000	1,710,000
Over 60 per cent	1,895,000	1,895,000	1,935,000

[1] Marginal deduction rates are for working heads of 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.

Note: Figures are cumulative. Estimates for the 2011-12 tax benefit system are calibrated to tax credit statistics for April 2010, and earlier data for housing and council tax benefits.

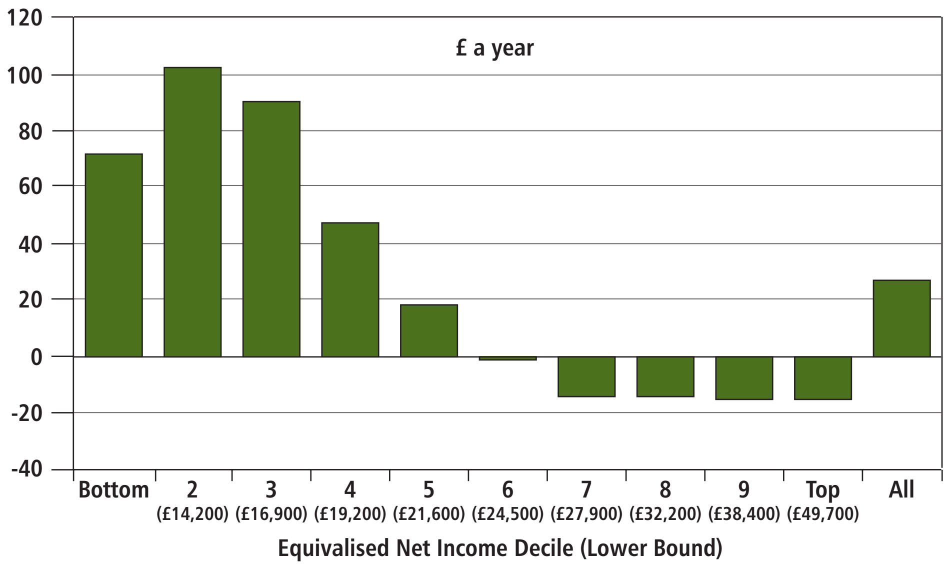
Source: HM Treasury

Impact of freezing Child Benefit and increases to the Child Tax Credit

A.20 This Budget includes measures to reduce welfare spending, alongside other reforms to reduce the deficit. Steps have been taken to protect low income families with children from the impact of these changes, by freezing the rate of Child Benefit to partly fund above indexation increases to the Child Tax Credit. This ensures that the overall impact of all modelled Budget changes on child poverty in 2012-13 is statistically insignificant.[8]

A.21 Chart A5 shows the impact of holding rates of Child Benefit constant and funding above indexation increases to the Child Tax Credit, as an absolute amount. In combination these measures have a progressive impact.

Chart A5: Impact of Child Benefit freeze and above indexation increase in Child Tax Credit in April 2012 in cash terms (£ a year), by income decile

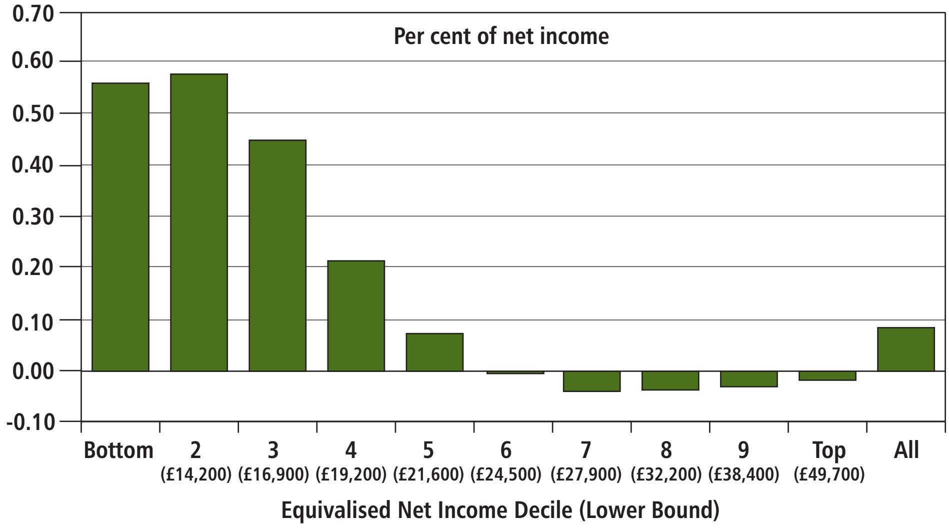


Source: HM Treasury tax and benefit micro-simulation model.

A.22 Chart A6 shows that the pattern shown in Chart A5 above in absolute terms also holds in relative terms.

[8] Estimates calculated using HM Treasury tax and benefit micro-simulation model.

Chart A6: Impact of Child Benefit freeze and above indexation increase in Child Tax Credit in April 2012 as a per cent of net income, by income decile



Source: HM Treasury tax and benefit micro-simulation model.

Basic State Pension

A.23 The Government is supporting pensioner incomes by reforming the uprating rules for the basic State Pension. The changes, including the introduction of the triple guarantee, will benefit over 11 million pensioners in the UK. The standard minimum income guarantee in Pension Credit will have an above indexation increase in April 2011 to ensure the lowest income pensioners benefit from the basic State Pension's triple guarantee.