Budgeting for fairness? The distributional effects of three Labour Budgets

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1. Introduction

One of the Gordon Brown's keywords as Chancellor over the last two years has been fairness. In this paper we examine the impact of the recent budget and the two previous budgets on the distribution of household incomes in the country as a whole. We ask the following questions:

- Have Labour’s changes to taxes and benefits mainly benefited the rich or the poor?
- What has been the effect on middle income households?
- How have families with children - the group that the Chancellor aimed to target - fared?

We compare the effect of the policy in place when the Labour government came to power in May 1997 with that announced in last Tuesday's Budget. We use the Microsimulation Unit's tax-benefit model POLIMOD to show the effects of Labour's changes in personal tax, social security and the introduction of the minimum wage on the disposable incomes of British households.

Traditionally, Budget analysis consists of calculation of the "overnight" effects on particular families. Our analysis departs from this in two respects. Firstly, the use of survey data, representative of the actual population, allows us to assess the overall distributional effects. We capture the diverse range of living situations and individual characteristics in the UK today in the correct proportions. Secondly, we have responded to the recent trend for announcing changes several years in advance of their implementation, by "rolling together" all the announced changes as though they were to come into affect in April 1999. This has the advantage of allowing us to focus on the overall direction of policy, without getting involved in the complexities of the timing of the changes.

We compare policy as it existed in May 1997, indexed for increases in prices to 1999/2000 levels, with the full set of changes announced by the Chancellor in the recent Budget and the two previous Budgets.

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1 We are grateful to Howard Cobb and Heather Henchie for technical support.
2 POLIMOD makes use of micro-data from the Family Expenditure Surveys (FES) of 1994/4 and 1995/6, updated to the price and income levels projected for 1999/2000. The FES data are Crown Copyright. They have been made available by the Office for National Statistics (ONS) through the Data Archive and are used by permission. Neither the ONS nor the Data Archive bear any responsibility for the analysis or interpretation of the data reported here. POLIMOD is the tax-benefit microsimulation model constructed by the Microsimulation Unit in the Department of Applied Economics at the University of Cambridge, originally funded by the ESRC (R000 23 3257).
3 On the other hand, some of the timing issues are important. For example there will be a year between the abolition of the married persons' allowance (and additional personal allowance) and the introduction of the children's tax credit. Families with children will gain less during that period than indicated here.
The next section lists the changes that we include in our analysis. Section 3 shows the overall distributional effects of the changes. In section 4 we focus on the effects on households with children and section 5 summarises our conclusions.

2. The changes included in the analysis

A. Changes announced before Budget 99:

(amounts in £ per week unless otherwise specified)

- **Working Families Tax Credit replaces Family Credit**
  Tapered at 55%, instead of 70% for Family Credit.
  ‘Applicable amount’ of £90, £9.35 higher than under Family Credit.
  Rates for children aged under 11 increased.

- **One parent benefit**
  Reduced in line with increases in child benefit.

- **Child benefit**
  Increased by £2.50 to £14.40 for eldest child.

- **Income support**
  Increased by £2.50 for children aged under 11.
  Family premium increased to match change in child benefit.
  Lone parent premium frozen to bring it into line with Family Premium.
  Severe disability premiums increased.
  Pensioner premiums increased.

- **Housing benefit, council tax benefit**
  Allowances increased to match those in income support.

- **National Insurance Contributions**
  Employees Class 1: 2% entry fee on earnings below the Lower Earnings Limit abolished.

- **VAT**
  VAT on domestic fuel cut from 8% to 5%.

- **Minimum wage**
  Introduced at £3.60 per hour for workers aged 22 or over and £3.00 per hour for workers aged 18 to 21.

B. Budget 99 measures:

(in £ per week unless otherwise specified)

- **Children’s Tax Credit**
  £8 per family with children, tapered if one parent is a higher rate taxpayer, at rate of £1 for every £15 of income taxed at higher rate.

- **Working Families Tax Credit**
  Adult credit increased by £2.50. Adult credit further increased by £8 on the assumption that changes are made to allow all non-higher-rate taxpayer families to benefit from the children’s tax credit to the same extent.
  Credit for children under 11 increased by £5.80

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4 The size of some of the changes may not appear to be the same as those announced in the Budget. This is because we have made the changes using 1999/2000 price and income levels. Some of the announced changes make assumptions about the rate of inflation between next year and the following two.
• **Child benefit**
  Further increase of 60p to £15 for first child and 40p to £10 for subsequent children.

• **Income support**
  Allowance for children under 11 increased by £5.80
  Allowances for children of all ages increased by 40p to match increase in child benefit for second and subsequent children.
  Family premium increased to match increase in child benefit for eldest child. Family premium further increased by £8 so non-working families benefit from children’s tax credit to the same extent as taxpayers.
  Pensioner premiums increased so that income support for pensioners (“Minimum Income Guarantee”) reaches £78 for a single person and £121 for a couple.

• **Housing benefit, council tax benefit**
  Allowances and premiums increased to match increases in income support and child benefit. Family premium also increased, by assumption, to match the amount of the children’s tax credit.

• **Winter fuel allowance**
  £100 per year winter fuel allowance for households containing a person over state pension age or in receipt of income support pensioner premium.

• **Income tax**
  10p lower rate on first £1500 of annual taxable income (replaces 20p lower band).
  22p basic rate (replaces 23p).
  (20p tax rate on investment income below basic rate limit retained)

• **Income tax personal allowances**
  Age-related personal allowances increased above statutory indexation to £5720 (age 65-74) and £5980 (age 75+) per year.

• **Married Couple’s Allowance (MCA)**
  Abolished for couples both aged under 65.
  Additional Personal Allowance also abolished.
  Age-related MCA increased above statutory indexation to compensate for reduction of rate from 15% to 10%.
  Increase is from £3415 to £5125 for a couple where at least one spouse is aged 65 to 74 and from £3455 to £5195 for couples where at least one of the spouses is aged 75 or over.

• **MIRAS**
  Abolished.

• **National Insurance Contributions (NICs)**
  Employee Class 1: lower earnings threshold (LEL) for payment of employee NICs raised to level of income tax personal allowance at £83. UEL raised proportionately to £550.
  Self-employed Class 2: weekly flat rate reduced from £6.35 to £2.
  Self-employed Class 4: Rate up from 6% to 7%. Profits threshold (LPL) for payment of Class 4 NICs lowered in line with the weekly equivalent of the income tax personal allowance of £83.

• **Excise Duties**
  5% real increase in tobacco duties (in line with the “escalator”).
  6% real increase in road fuel duties (1% ahead of the “escalator”).
  Real reduction in duties on alcoholic drinks.
  Increase in insurance premium tax from 4% to 5%.
  Reduction in pools betting duty from 26.5% to 17.5%.
3. The distributional effect of three Labour budgets

The overall effect on household incomes of the changes listed in the previous section is shown in Figure 1. This plots the average percentage change in household income in each of ten, equal-sized income groups - or “deciles”\(^5\). The bottom group - containing the households with the lowest incomes - gain on average by 9.2 per cent of their incomes. The top ten percent also gain on average – by 0.3% of their incomes. In cash terms, the 10% of households with the lowest incomes benefit by an average of £7.90 per week, and the top 10% by £2.20 per week.

The impact on income distribution is clearly progressive: the lower the income, the higher the average proportional gain in household income.

**Figure 1 Average percentage change in post-tax incomes following the three Labour budgets**

![Graph showing average percentage change in post-tax incomes across deciles.](image)

Source: POLIMOD

Although on average each income group gains, there are both gainers and losers within each of the deciles. In Figure 2 we show the proportions of households gaining and losing, distinguishing between changes of more and less than £10 per week.\(^6\)

It is important to contrast the results of Figure 2 with Figure 1. While on average households in all income groups benefit from the reforms introduced since May 1997, a sizeable proportion of households - 20.1% - are actually worse off. These are distributed right across

\(^5\) We have adjusted household income to account for differences in size and composition using the McClements equivalence scale. POLIMOD assumes that some families who are entitled to means-tested benefits do not in fact receive them. The take-up probabilities for family credit, housing benefit, council tax benefit and income support are those estimated by the Department of Social Security. (We assume that the take-up rate of Working Families Tax Credit will be the same as that for family credit.)

\(^6\) We classify gains and losses as being changes of more than 10p per week.
the income distribution, with the largest proportion of losers in the poorest (28.1%), and the richest (39.2%), income deciles. However, only an insignificant number of households at any income level lose more than £10 per week.

**Figure 2 Percentage of gainers and losers following three Labour Budgets**

![Figure 2 Percentage of gainers and losers following three Labour Budgets](image)

Source: POLIMOD

**4. Were they budgets for children?**

In this year’s Budget speech, the Chancellor emphasised that the “interests of children must be paramount” and stated his intention to reverse the trend of rising tax burdens for families with children. According to POLIMOD, the average cash gain of households with children is more than twice that of households as a whole.

Children are not evenly distributed across the household income distribution. Figure 3 shows the share of the overall number of households with children in each decile (dotted line). It can be seen that in general, households with children are more concentrated among the low-income groups.

Figure 3 contrasts the percentage change in income of households with children (light bars) with the changes for all households in the same income group (darker bars – same as in Figure 1). This shows that the distribution of the gain to households with children is even more concentrated on low-income households than over the population as a whole. Across the entire income distribution, households with children benefit by a greater amount than households on average. This difference is particularly pronounced in the lower deciles.
Although the three Labour budgets have improved the incomes of households with children, there are also losers. Figure 4 shows that, although a clear majority of households with children benefit from the new measures, a considerable proportion of households with children in the poorest (15.1%) and richest (32.0%) income groups are worse off than they would be under the policy existing prior to the 1997 election. Many of the low-income losers with children are lone parents.

On the other hand it is notable that the great majority of households with children in the bottom half of the distribution gain by more than £10 per week. In the middle income groups, very few households with children are net losers: nearly all gain, with those gaining most tending to be households with lower incomes.
5. Concluding comments

The three Labour budgets contain changes which together significantly redistribute resources towards low-income households. The lower the income on average, the higher the proportional increase in income.

On average no income group are net losers, but households who are worse off are scattered throughout the distribution. 20% lose overall with somewhat higher numbers among both the poorest and the richest households.

Households with children benefit in particular. Those in the poorest income group find their incomes increase by 16% on average, in spite of the fact that some 15% of the group are net losers. Although less than a third of all households contain children, nearly two-thirds of the total benefit from the three budgets accrues to these households.

Of the total resources channelled towards households in the three budgets, households in the bottom half of the income distribution receive a share of 61% of the total. The top 10% receive just a 3% share. It is worth reflecting that figures calculated in a similar way following the Lawson budget of 1988 showed that 50% of the "give-away" went to the households with the top 10% of incomes, while just 10% went to the bottom 50% of households. Gordon Brown has not managed to fully reverse the massive redistribution – or increase in "unfairness" - that took place under the Conservative governments. But he has made a start.

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