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Keeping up or falling behind? The impact of benefit and tax uprating on incomes and poverty

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NON-TECHNICAL SUMMARY

Each year, the Government decides how much to raise benefits and tax allowances, a process known as ‘uprating’. Different uprating methods are applied to different parts of the tax and benefit system, including uprating in line with earnings, uprating with inflation and no uprating at all. The basis for these upratings is rarely debated, yet has major long-term consequences for the relative living standards of different groups and for public finances. For example, it will be virtually impossible for the government to end child poverty if payments for families with children rise more slowly than other incomes.

This paper aims at making more visible the scale and implications of current uprating conventions, and of some alternatives, for income distribution, poverty rates and the public finances. To create greater clarity about the long-term effects of different uprating regimes, it considers what would happen over a 20 year period from 2006/7 under various policy scenarios, if everything else stayed the same.

Results show that today’s uprating systems imply substantial long-term reductions in personal disposable incomes relative to earnings. While all groups will be affected, those with the lowest incomes will be hit hardest, causing widening economic inequality. Some or all of the extra money raised may be needed for public spending to pay for demographic change and improving services. However, the raising of these funds appears unfair, falling disproportionately on poorer groups. A more open debate about this often hidden area of public policy may lead to different choices about how much extra money is needed and who should pay for it. Above all, this would mean that decisions that prevent the poorest members of society from keeping up with rising living standards would not be taken in the dark.

Keeping up or falling behind? The impact of benefit and tax uprating on incomes and poverty[1]

By

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Abstract

Each year, the Government decides how much to raise benefits and tax allowances. In the UK the basis for these upratings is rarely debated, yet has major long-term consequences for the relative living standards of different groups as well as for the public finances. This paper considers the medium term implications of present uprating policies which vary across parameters of the tax-benefit system. Continuing for 20 years, other things staying the same, would result in a near doubling of the child poverty rate alongside a substantial gain to the public finances. At the same time pensioners are largely protected by the earnings indexation of pensioner benefits and, in time, the basic state pension. We show how difficult it will be to meet the UK child poverty targets unless the greater inequality inherent in the current regime for uprating payments and allowances is redressed.

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I. INTRODUCTION

Over time, the way in which benefits and income tax allowances are adjusted for inflation (in UK parlance, 'uprated') can have large implications for the distribution of incomes and for public spending. The social security budget in Great Britain was £118 billion in 2006-07. A decision to increase all its parameters in line with earnings growth in 2007-08 would have meant a cash increase of about £4 billion. If it had all been increased in line with the Retail Prices Index, the cash increase in spending would only have been £2.8 billion. To put it the other way round, a decision to freeze all the cash values of the system would have meant 2007-08 spending around £4 billion less than a decision to preserve the value of all benefits relative to earnings. In the long term the failure of benefit incomes generally to keep pace with other incomes has been one of the biggest influences on the widening of living standards (Bradshaw and Lynes 1995; Hills 2004 pp 90-93).

Such adjustments can also lead to structural changes in policy. Part of the recent UK debate around pension reform has centred on the long-term structural consequences of uprating the basic state pension by price inflation, while the means-tested minimum income for pensioners was increased in line with earnings growth (Pensions Commission, 2006).

Uprating rules also have particular relevance at present for the prospects for meeting the government's child poverty reduction targets of halving the rate by 2010 and eliminating it in 2020, especially those measures that are set as the proportion of children with household income less than 60 per cent of the contemporary median. If median income rises faster than benefit incomes, then meeting the targets will be virtually impossible (Brewer et al. 2007; Evans and Scarborough 2006; Glennerster et al. 2004; Hirsch 2006; Sutherland et al. 2003).

Despite their importance, many adjustments to benefits and tax allowances are made – or not made – by default and with little debate. When breaking the pensions-earnings link in 1979, the Secretary of State, Patrick Jenkin, said that pensioners could still look forward to "sharing in the increased living standards of the country as a whole" (Bradshaw and Lynes, 1995, p.15), rather than this being debated as a long-term change in policy towards price-uprating. Adjustments also follow a widely varying set of rules (see Section II). The principles that may lie behind these rules are discussed in Sutherland et al (2008). While there may be good reasons for different rules where the objectives of parts of the tax and benefit system vary, it is by no means clear that either the public or politicians understand the long-run implications of these rules.

This paper presents analysis of the consequences for incomes, poverty and reliance on means-tested benefits of different uprating practices. The next section describes recent practice in the UK. Data and methods are set out in Section III. Section IV explains how we assume the UK system would evolve if recent conventions continued to be followed, taking account of the structural reforms to the direct tax and tax credit systems announced up to the 2007 Budget. Section V examines the implications of recent conventions and stated policy regarding uprating (our "base case"), looking over the medium-term (20 years) and explores how much of the base case is due to effects on benefits and how much on taxes. Continuing recent conventions would, other things being equal, produce a very substantial boost to the public finances, as well as substantially increasing relative poverty. Section VI looks at the implications of alternative scenarios that would involve less gain to the public finances and smaller rises in poverty. These alternatives include uprating benefits or reducing income tax by more than under current policy, and targeting more generous uprating on particular benefit recipients (children or pensioners). In Section VII we look at levels of income for the older population, in particular examining the implications of the reforms introduced by the 2007 Pensions Act by comparison with previous indexation conventions for state pensions. Section VII concludes.

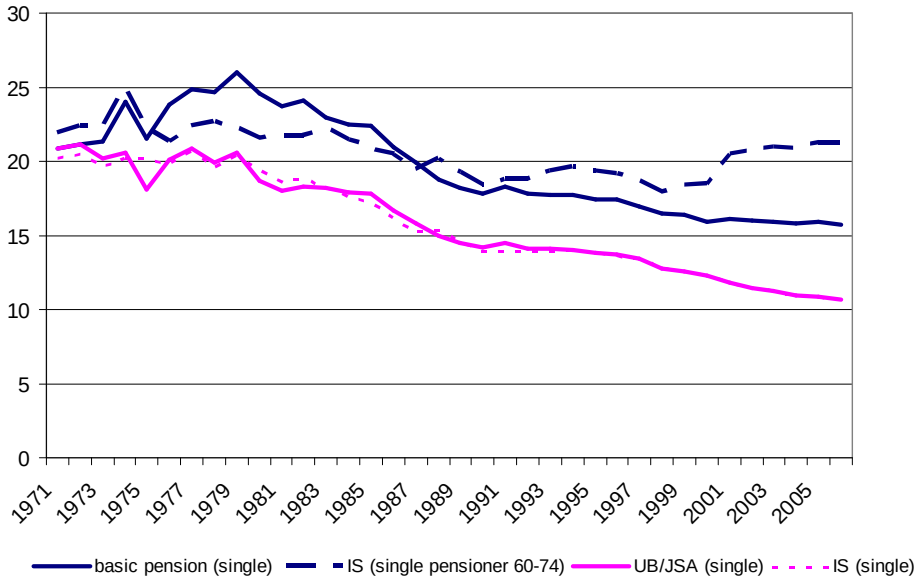
II. RECENT PRACTICE IN THE UK

Since the 1980s most social security benefit levels in the UK have been uprated annually, by retrospective movements in the Retail Prices Index (RPI). Means-tested benefits are uprated by the "Rossi" index which excludes housing costs and local taxes since these costs are supported directly. However, a few – such as the Guarantee Credit for pensioners and the child rates within the Child Tax Credit – are currently adjusted by average earnings.

The legal requirements, as well as actual practice, for uprating also vary both across and within benefit types. There are statutory requirements to uprate some elements annually by prices, while for other aspects of the same benefit, uprating is discretionary, sometimes leaving parts of the system – such as capital limits and earnings disregards in Income Support – at the same nominal value for years.

The consequences of these differences in uprating practice can be very large, as can be seen in Figure 1.

Figure 1: Benefit values as percentage of average earnings, 1971 to 2006



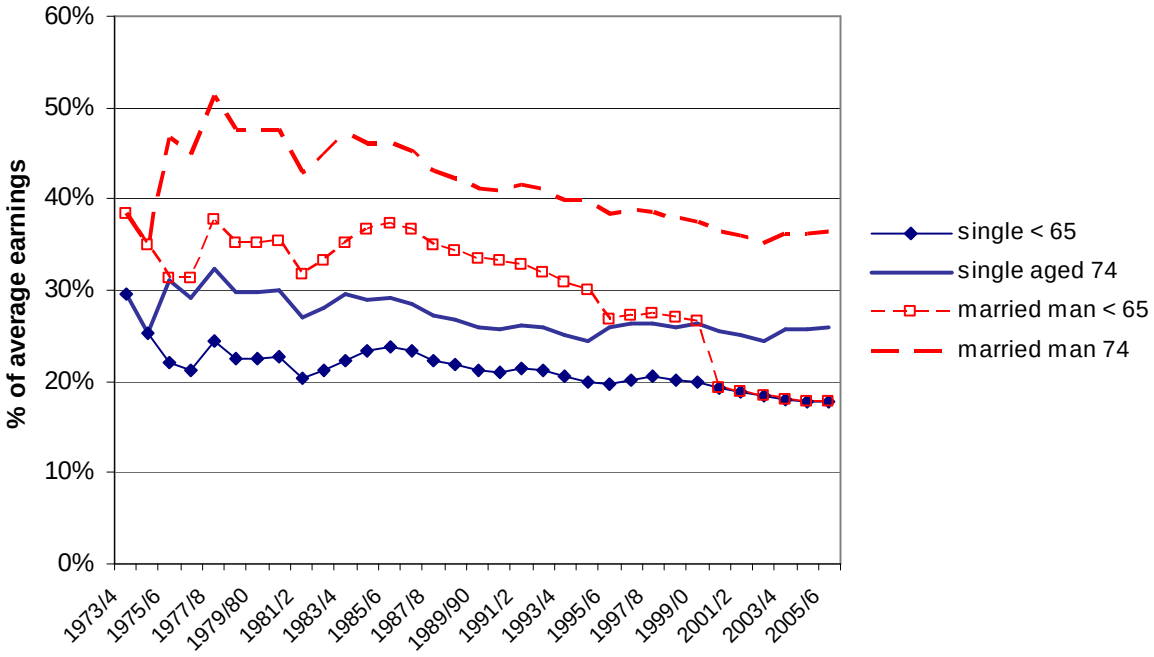
Source: DWP, Annual Abstract of Statistics (2006).

In the 1970s, a single person received Supplementary Benefit (now Income Support) or flat rate Unemployment Benefit (now Jobseekers' Allowance) worth around 20 per cent of average earnings. By 2004, the equivalent was worth only 11 per cent of average earnings. In the early 1980s, the basic pension was worth a quarter of average earnings, now its (generally) price-linked value has fallen below 16 per cent of average earnings. Of those benefits shown, only Income Support for younger pensioners (now the Guarantee Credit) has (nearly) regained, and recently held, its relative value of the late 1970s.

Equally, the tax structure has changed over time, as some thresholds have been more or less generously increased than others. Figure 2 shows the points at which different kinds of people would start to pay income tax or make National Insurance contributions, expressed as a percentage of average earnings since 1973. The gradual reduction in value of the thresholds relative to earnings over time is evident. The main single personal income tax allowance has generally been increased in line with price inflation,[1] while the tax thresholds for single pensioners (benefiting from the "age allowance") have tended to retain their values better in relation to earnings since the early 1990s. In recent years tax allowances for pensioners have followed the value of the Guarantee Credit in order to exempt recipients from income tax and are therefore *de facto* earnings indexed.

[1] Since 1977 when the Rooker-Wise amendment to the Finance Act made increasing personal allowances in line with inflation a statutory commitment, indexation with prices (at least) has occurred in most years. This did not happen in 1981-82, 1993-94, 1994-95 or 2003-04 when the main single allowance was frozen.

Figure 2: Income tax and National Insurance contribution effective thresholds in relation to average earnings 1973-04-2005-06



Notes: Sources: HMRC information on income tax allowances, reliefs and rates
http://www.hmrc.gov.uk/stats/tax_structure/menu.htm
Average earnings for full time adult employees from DWP Annual Abstract Table 3.2, based on NES/ASHE.

Between 1994-95 and 1999-00 for all married people and until 2005-06 for those over pension age, calculations show the effective threshold, taking account of the fact that married allowances were/are allowed at a restricted rate. No account is taken of tax credits or other concessions for children.

The former Married Couples' Allowance in income tax was reduced in value even in relation to prices in the 1990s. The married allowance for working age couples was finally abolished in 2000-01 although many of its recipients were compensated the following year by the introduction of the Children's Tax Credit, which is not shown. This illustrates the difficulty in recording the history of uprating practice, since structural changes to the system ("reforms") occur alongside regular uprating. Indeed, the downward trend in the value of thresholds compared with average earnings should not be taken to imply that tax burdens have risen. Other changes within the income tax structure – notably reductions in tax rates - have more than compensated for fiscal drag, at least on average. For example, the proportion of income taken in income tax of a single childless person on mean earnings (and no other income) fell from 19.7 per cent in 1990-91 to 16.8 per cent in 2001-02, rising again to 17.2 per cent by 2004-05.[2]

[2] HMRC Table 2.7 http://www.hmrc.gov.uk/stats/t_expenditures/menu.htm.

III. DATA AND METHODS

Our analysis uses two microsimulation models to investigate the effects of current and alternative upratings policy. We use the static tax-benefit model, POLIMOD, (Redmond et al. 1998) to examine the impact on the whole population (sections V to VII) looking at the impacts of the future systems *as if* they had been in force in 2006-07. Taking a slightly different perspective, the dynamic microsimulation model CARESIM (Hancock et al. 2007), is used to investigate the position of pensioners in more depth. Both models use data from the 2003/4 UK Family Resources Survey updated to 2006/7. POLIMOD simulates income tax and National Insurance contribution liabilities and entitlements to universal and means-tested benefits and tax credits for the whole population. CARESIM is restricted to people aged 65 and over. CARESIM also 'ages' the sample through time and so can be used to estimate the incomes of those members of the sample likely to be alive at future points in time. Both allow for non take-up of means-tested benefits using consistent assumptions on take-up rates. Further details are given in Sutherland et al. (2008).

Most results are expressed in *earnings* terms.[3] This shows what future tax and benefit systems would "feel like" if applied to current incomes and allows us to concentrate on the long-run impact of indexation rules, abstracting from other factors that will affect the actual distribution of incomes in the future – such as the ageing population, or the maturing of pension rights. It is equivalent to making the assumption that all components of gross income *other than* those set by the state through tax and benefit rules grow in line with earnings, and then expressing the results in 2006-07 earnings terms, and abstracting from changes in population composition. In reality as time goes by many features of the population and of the income distribution will change. Our results are therefore not forecasts of the future but a way of isolating the medium-term implications of different indexation regimes. Section VIII takes a different perspective. It looks at how the incomes of today's over 65s are likely to evolve in practice as they age and also draws comparisons between now, 6 and 20 years' time in the projected incomes of different age groups within the older population.

[3] Future cash amounts are adjusted back to 2006-07 values by expected future growth in average earnings. In sections V to VII, where we look at the impacts of the future systems as if they had been in force in 2006-07, the adjusted tax and benefit parameters are applied to the population distribution of other gross incomes as they actually were in 2006-07.

The distributional effects of alternative uprating policies are shown by examining the consequences for the household incomes of individuals in each decile of the household income distribution. Incomes are measured both before and after the deduction of housing costs following conventions used in official statistics (Department for Work and Pensions, 2007). We also consider the implications for headcount poverty and the median poverty gap – the median proportion by which the incomes of those in poverty fall below the poverty line. In line with current policy commitments to reduce poverty in relative terms (for families and pensioners at least) we use *relative poverty lines*. These are assumed to move in line with the growth of median disposable incomes, as modelled for the base case in Section IV. They grow somewhat more slowly than average earnings as a result of the way in which components of median incomes – essentially many benefits – adjust in value over time, and as a result of the effects of fiscal drag leading to rising taxes as tax thresholds increase more slowly than gross incomes.

The effect of uprating policies on the proportions of people projected to receive means-tested benefits is also examined. Means-testing contributes to high marginal effective tax rates through benefit withdrawal as income rises and may therefore reduce the incentive to work. Recipients may feel stigmatised and also there is a view - reflected in the provisions of the Pensions Act (Department of Work and Pensions, 2006a) - that high levels of dependency on means-tested payments reduce the incentive to save for retirement. On the other hand, if the alternative to receipt of such benefits is simply lower income, then rates of receipt can also be indicative of the extent to which income is underwritten by the means-tested system. Thus receipt of a means-tested benefit or tax credit is viewed here neither as purely a positive nor a negative feature, simply as an indication of how the system as a whole is working.

IV. CONTINUING CURRENT UPRATING CONVENTIONS

To examine the long-run implications of current indexation conventions, we first compare outcomes under the current system with the systems that would emerge if those conventions were continued in the medium-term, for twenty years. This requires the levels of benefits and other parameters of the tax and benefit system to be projected forward. As Section II above makes clear, there are aspects of current uprating practice that are explicit, with clear government commitments to one approach or another. There are others where reforms have been announced for the future. But in many cases, actual policy is decided from year to year.

For many of these, recent practice has followed implicit rules which it is reasonable to assume will continue unless an explicit reform is announced. But for some aspects of the system it is less clear what "business as usual" would entail, and a judgement has to be made. This section summarises the assumptions we have made on which our "base case" projections in later sections are based. Details are given in the appendix, which also explains the assumptions used in constructing the indices. In summary:

(a) *Price indexed (with Retail Prices Index):* The default assumption for all social security benefit and tax credit amounts and thresholds unless specified below; income tax and National Insurance contribution thresholds.

(b) *Price-indexed (with "Rossi" index):* Income Support; Housing Benefit and Council Tax Benefit applicable amounts (except for pensioners and children)

(c) *Earnings-indexed (using an Average Earnings Index):* Child elements of the Child Tax Credit (until 2009-10); Guarantee Credit threshold for pensioners; basic pension (from 2012-13); Savings Credit threshold (from 2009-10 to 2014-15).

(d) *Fixed in nominal terms:* The family and baby elements of Child Tax Credit; the Child Tax Credit and Working Tax Credit income threshold; capital limits for receipt of means-tested benefits; additional basic pension at 80; winter fuel payments to pensioners; earnings and other disregards in Income Support, Housing Benefit and Council Tax Benefit.

Taking account of the reforms to state pensions enacted in the 2007 Pensions Act, the re-linking of the basic pension to earnings is assumed to take place in 2012 (although this date is not yet a firm government commitment). In extrapolating uprating policies up to 20 years ahead we have had to make some judgements about how stated policies will apply over time. In particular:

- Income tax age allowance uprating is assumed to be on the same basis as Pension Credit guarantee uprating (i.e. with earnings).
- Elements of benefits that have not been regularly uprated in the past are assumed to be frozen throughout the 6 and 20 years considered here.
- As implemented in the 2007 Pensions Act, the Pension Credit Savings Credit lower threshold is uprated by earnings from 2008 until 2014. From then on, it is computed as a

function of the maximum payment (which will be price (RPI) uprated) and the Guarantee Credit level.

- There is a commitment to earnings uprate the Child Tax Credit child amounts until 2009-10. After that time we assume a return to price (RPI) uprating.[4]

Further structural reforms to the income tax and National Insurance contribution systems and to benefits and credits were announced in the 2007 Budget. [5] Our results incorporate these reforms into the starting point and the tax-benefit systems that follow from different indexation regimes. This allows us to isolate the implications of indexation rules as they unfold within the tax and benefit structures that had been announced up to November 2007 but do not include changes announced after that date. However, it should be clear that the precise structure at the starting point is not the main issue: it is the longer term effect of uprating relative to the starting point that is the focus of this paper.

V. IMPLICATIONS OF CURRENT INDEXATION RULES

In this section we consider the ways in which current indexation rules – the "base case" described in Section IV – would change the impact of the benefit and tax systems if continued for 20 years to 2026-27. Continuing with prevailing uprating policy for 20 years would generate substantial benefits to the government budget compared with comprehensive uprating in line with earnings: a saving in 2006-07 terms of £47 billion after 20 years, or around 3.6 per cent of GDP.[6]

This corresponds to a sizeable reduction in household disposable incomes: 8 per cent in aggregate, relative to earnings. The distributional effect of this relative reduction in income (or, put another way, of current uprating policy compared with what would happen under

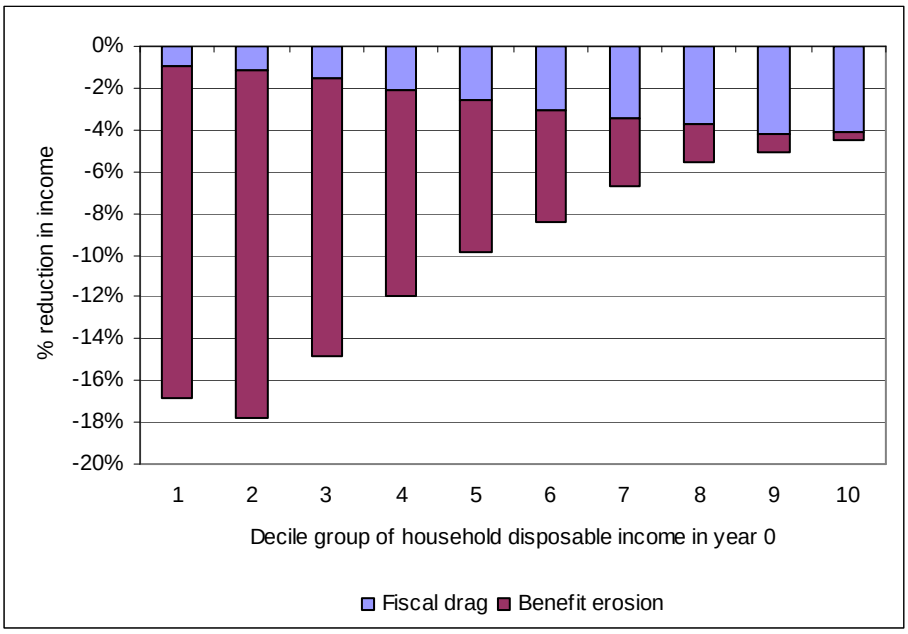
[4] While there is some expectation in policy circles that earnings uprating will be extended for a longer period, there is no stated policy on this so we retain price uprating as the default.

[5] The main features of these Budget announcements were the abolition of the initial 10 per cent income tax band (in 2008); the reduction in the basic rate of income tax from 22 to 20 per cent (in 2008); an increase in the Upper Earnings Limit for NICs to equal the threshold for payment of income tax at 40 per cent (by 2009), with the latter threshold increased by more than inflation (in 2009); above-inflation increases in values of tax credit thresholds (in 2008) and maximum CTC child element (in 2008) and in the age allowances for income tax (in 2008 and 2011); an increase in the tax credit taper from 37 to 39 per cent (in 2008); and a slightly greater increase in Child Benefit for the first child than implied by price indexation alone (by 2010). See Sutherland et al. (2008) for more details.

[6] Note that these estimates do not include the effect of continuing to index the thresholds for *employer* National Insurance Contributions (NIC) with prices. It is likely that in practice these would move consistently with *employee* NIC thresholds.

earnings uprating) is shown in Figure 3. This plots the proportionate change in before housing costs (BHC) income for each decile group of the income distribution. The effect of 20 years of current indexation conventions for individuals in the bottom two tenths of the distribution would be a reduction in income of around a sixth. The poorest tenth, for instance, who are largely dependent on cash benefits, would see their incomes fall by 17 per cent. The further up the income distribution one looks, however, the more closely would net incomes keep up with gross earnings with the top decile losing less than 5 per cent of their income in relative earnings terms.

Figure 3: Distributional effects of current uprating policies after 20 years in relative earnings terms



Source: POLIMOD using FRS 2003-04
Notes: Decile groups are defined according to the household disposable income of individuals at the starting point, equivalised using the modified OECD scale.

Figure 3 distinguishes the separate contributions of fiscal drag and the corresponding reduction in the relative value of benefits, which we term "benefit erosion". Not surprisingly fiscal drag would bear much more heavily on higher- than lower- income households. Indeed, nearly all of the negative effects in the top decile groups would be due to fiscal drag rather than the loss in the relative value of benefits.

Benefit erosion, as expected, has most effect on lower-income households – the 16 per cent losses due to benefit erosion shown here for the bottom two tenths accounting for nearly all of the losses from the combined change. Perhaps less expected is the fact that not only would

benefit erosion play a much bigger role than fiscal drag at the bottom of the distribution (and the reverse at the top), but the aggregate size of the benefit erosion effect would be larger. While fiscal drag would be raising £20bn in additional government revenue per year by 2026-27 relative to earnings indexation, benefit erosion would be reducing spending by £27bn per year, or 57 per cent of the total gain to the public finances. Even for middle income households benefit erosion is the potentially more important contributor to falling relative incomes than fiscal drag: it would account for 69 per cent of the reduction in income of the middle quintile, relative to earnings. Combined, fiscal drag and benefit erosion have proportional effect on incomes that is four times the size for the bottom 20 per cent of the population as it is for the top 20 per cent. Moreover, it is clear that reducing or eradicating fiscal drag would do very little to lessen the effect at the bottom. Addressing benefit erosion, one way or another, is necessary, if this effect is to be avoided.

Since continuing to uprate according to current indexation conventions would result in net incomes falling relative to earnings, poverty lines measured in relation to median net incomes would also fall slowly in relative earnings terms. However, the implication of the distributional pattern shown in Figure 3 is that the numbers below relative poverty lines would increase. As shown in Table 1, measured before housing costs the overall poverty rate would rise from 17 to 23 per cent after 20 years and the trajectory is similar for poverty measured after housing costs. The impact on pensioner households would be comparatively modest (indeed, after housing costs, the pensioner poverty rate would be slightly lower after 20 years of the base case). This reflects the way in which important parts of the benefit and tax system for pensioners are – or will be during the period considered – earnings-linked. However, the rise in child poverty is steep and dramatic. On an after housing costs (AHC) basis it would rise from 27 per cent at the starting point to 39 per cent after 20 years. The increase in the BHC rate would be even more dramatic, rising from 18 per cent at the starting point to 33 per cent after 20 years. Instead of eradicating child poverty, the effect of continuing current uprating policies would be almost to double it, other things being equal.

Those who are poor after 20 years of base case uprating would be further below the poverty line than the poor typically are at the start of the process. After housing costs the typical poverty gap would rise from 23 to 35 per cent of the poverty line. Not only would the *numbers* in relative poverty have risen substantially, but so would the *depth* of their poverty.

Table 1: Relative poverty in the UK after 20 years of base case uprating and under fiscal drag and benefit erosion alone

	Starting point	Base case	Fiscal drag only	Benefit erosion only
BHC Median £/week	*364*	*334*	*353*	*344*
Poverty ***rates***: All	17	23	16	24
Children	18	33	16	33
Pensioners	23	24	22	26
Poverty ***gap*** (median) %	19	22	18	23
AHC Median £/week	*311*	*280*	*300*	*291*
Poverty ***rates***: All	21	25	20	26
Children	27	39	25	39
Pensioners	16	14	14	19
Poverty ***gap*** (median) %	23	35	23	35

Source: POLIMOD using FRS 2003-04

Notes: Poverty rates are calculated as the number of people living in households with equivalised income below 60 per cent of the within-scenario median. The modified OECD equivalence scale is used with Before Housing Costs (BHC) incomes and the "companion "scale is used with After Housing Costs (AHC) incomes (see DWP, 2007; page 189)

Not surprisingly, it is benefit erosion that contributes most to the rise in poverty rates. Benefit erosion on its own would result in poverty rates that would be even *higher* than from the two effects combined (shown in Table 1). By contrast, fiscal drag for 20 years would cause relative poverty rates to be slightly *lower* than they are at the starting point: it has little effect on the incomes of the poor or those on the margins of poverty, but reduces median income, and hence depresses the relative poverty line slightly compared to the base case.

Another consequence of benefit erosion is a change in the extent of reliance on means-tested incomes. Over all types of means-tested benefit and tax credit,[8] the proportion of people in receipt falls from 43 per cent at the starting point to 30 per cent after 20 years of base case uprating (Table 2). This reduction is not due to fewer pensioners in receipt of Pension Credit (PC): this proportion remains roughly constant reflecting the indexation of the Guarantee Credit within PC by earnings over the whole period.[9] Nor is it due to reductions in the number on Income Support (IS), shown in Table 2 in terms of the number of children in families affected. While base case uprating reduces the relative size of IS payments, this has only a

[8] Income Support (IS), Housing Benefit (HB), Council Tax Benefit (CTB), Pension Credit (PC), Child Tax Credit (CTC, Working Tax Credit (WTC).

[9] The proportions are not exactly the same at the starting point and after 20 years because of the way the Savings Credit is uprated – see the Appendix. Note that, as explained in Section III, this is not a *forecast* of how many pensioners would be receiving Pension Credit in 2026-27, as it takes no account of factors such as the changing composition of pensioner income or the ageing of the population. As before, the comparisons isolate the impact of indexation processes by themselves.

small effect on the number of recipients because most working age IS recipients do not have substantial other incomes to fall back on. The main change is due to the numbers on in-work means-tested supplements being dramatically reduced as the size of payments on average, as well as the income threshold for tapering payments, falls relative to family income. The proportion of children in families receiving tax credits would be reduced to less than half within 20 years of base case uprating.

Table 2: Proportion of people in families in receipt of means-tested benefits or tax credits at the 2006-07 starting point and after 20 years of base case uprating %

	Starting point	After 20 years
All on any benefit or credit*	43	30
Children on CTC with IS	17	16
Children on CTC alone or with WTC**	49	23
Pensioners on PC***	32	33
Pensioners on any benefit	45	45
All on HB/CTB	21	21

Source: POLIMOD using FRS 2003-04
Notes * Income Support (IS), Housing Benefit (HB), Council Tax Benefit (CTB), Pension Credit (PC), Child Tax Credit (CTC, Working Tax Credit (WTC).
** Not including cases receiving the CTC family element only
*** Either Guarantee Credit or Savings Credit or both

It should be noted that the proportions on Housing Benefit (HB) and Council Tax Benefit (CTB) do not fall at all. For pensioners entitlement to these benefits is aligned with Pension Credit. For others, while income thresholds may be falling in relative earnings terms, we assume in our modelling that maximum amounts – corresponding to rent and Council Tax respectively - remain buoyant with earnings. Although some beneficiaries would find their entitlements dwindling as their incomes rise relative to the thresholds which are kept constant in real terms only, others would find these benefits fill the gap left by Child and Working Tax Credits, the thresholds of which would be falling in value relative to prices.

Associated with a reduction in the relative value of benefits, we might expect improvements in work incentives. However, this is not the case in all circumstances. For example, while out of work benefits fall in relative earnings terms, in-work benefits fall faster due to the freezing of the tax credit thresholds. For example, a lone parent would have an income out of work that is 64 per cent of that while working for 30 hours on the minimum wage at the starting point, but this proportion - or "replacement rate" - *rises* to 72 per cent after 20 years (see Sutherland et al., 2008). For those already in work, incentives to do so more intensively are on

the one hand improved to some extent for those no longer entitled to tax credits (although as explained above these may be replaced by HB and CTB), and worsened for those whose marginal rate of income tax rises due to fiscal drag.

VI. IMPLICATIONS OF ALTERNATIVE INDEXATION STRATEGIES

The analysis in the preceding section does not represent a forecast of what will actually happen to policies over the next 20 years. Some of the substantial revenue gains that current indexation conventions would generate might be used to keep the government accounts in balance without tax rises in the face of other pressures, such as improving public finances to meet the "Golden Rule", or the pressures from an ageing population. However, some proportion of them might be "given back" through periodic tax and benefit reforms or ad hoc tax "cuts". This has certainly been the experience of the last ten years. This section explores the distributional implications of what would happen if the revenue gains were partly offset through other changes to the tax or benefit systems. To do this, we consider three alternatives to the base case as follows:

a. Uprating benefits and tax credits at a higher rate than the current base case policy.

b. Uprating income tax and National Insurance contribution (NIC) thresholds at a rate higher than the current base case policy.[12]

c. Cutting income tax (and NIC) rates by some common proportion.

By way of contrast we also examine the effects of equivalent cost reforms which specifically target children or pensioners.

For illustrative purposes, we "spend" just part of the total. We consider what would be possible if around 40 per cent of the total were to be available after 20 years (£20 billion per year), leaving three-fifths of the base case revenue gain to be used for other purposes.[13] We term spending this proportion of total revenue as "public finance Scenario B" with the base case providing "Scenario A".

[12] Not including employer NIC thresholds.

[13] The proportion is calculated to correspond to the amount of revenue attributable to fiscal drag alone but this should not be taken to suggest that the revenue from fiscal drag should (or indeed could) be ring fenced in this way: we simply take this proportion of the total revenue in order to provide some sense of scale to an otherwise arbitrary choice.

In the case of benefit uprating option, all benefit and tax credit thresholds, disregards and payment amounts are uprated by the same annual factor over and above the index used in the base case, up to the equivalent of annual earnings uprating. The factor that uses up the revenue under Scenario B after 20 years is an increase of 1.87 per cent each year. So for a component that is price-uprated in the base case the uprating is somewhat less than what would happen under earnings uprating (assumed to be a 2 per cent on top of price indexation per year).. For elements that are frozen under the base case the values still fall in relative earnings terms but by less than they would under the base case.[14]

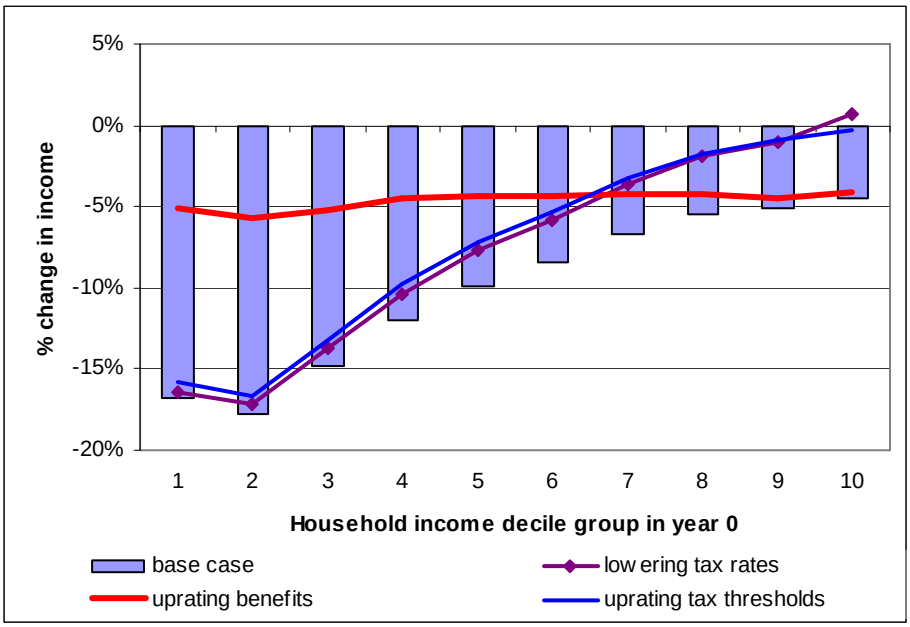
Spending the revenue under Scenario B on uprating tax thresholds is equivalent to uprating by earnings and reducing fiscal drag to zero. The additional factor in this case is therefore 2 per cent per year.

Spending the revenue under Scenario B on cuts in tax rates (including rates of employee and self employed NICs) would allow them to be cut proportionately by 11.9 per cent after 20 years. This corresponds, for example, to a cut in the basic rate of income tax from 20 per cent to 17.6 per cent.

Figure 4 shows the distributional effects of the combination of fiscal drag and benefit erosion, offset by each of the three changes described above after 20 years. The bars show the effect of the base case (as in Figure 3) and the lines plot the net income change (compared with the same starting point) under Scenario B with the revenue spent on the three generally applied options (a), (b) and (c).

[14] They fall to 56 per cent of their present value after 20 years instead of 39 per cent under the base case.

Figure 4: Distributional effects of base case uprating and alternative spending under Scenario B after 20 years



Source: POLIMOD using FRS 2003-04
Notes: Decile groups are defined according to the household disposable income of individuals at the starting point, equivalised using the modified OECD scale.

Tax "cuts"

As might be expected, both mechanisms based on reducing tax burdens would have their main effect among higher income households, with the reduction in tax rates having a slightly greater effect in the top decile group to the extent that the group as a whole would actually gain on average. The value of the tax cut would exceed losses under the base case.

Nevertheless, the political advantages in cutting tax rates make this scenario a not implausible outcome, if governments are committed to keeping the overall tax ratio constant.[15] The direct tax system would become less progressive as thresholds fall in relative terms, but tax rates are cut. Moreover, as shown in Table 3, neither reduction in tax and contributions does much to reduce the large rise in poverty rates due to benefit erosion.

[15] Indeed, the UK Treasury's long term fiscal projections assume a constant tax to GDP ratio (HM Treasury 2008: page 31), although benefits are generally assumed to be linked to prices.

Table 3: Relative poverty in the UK after 20 years of alternative uprating regimes

			Spending under Scenario B on:				
	Starting point	Base case	Benefit uprating	Increasing tax thresholds	Reducing tax rates	Child Tax Credit	Basic State Pension
BHC Median £/week	*364*	*334*	*349*	*344*	*343*	*351*	*351*
Poverty rates: All	17	23	18	24	24	16	22
Children	18	33	20	33	33	9	36
Pensioners	23	24	22	26	26	27	8
Overall median poverty gap %	19	22	18	23	23	23	25
AHC Median £/week	*311*	*280*	*295*	*291*	*289*	*299*	*300*
Poverty rates: All	21	25	22	26	26	18	25
Children	27	39	30	39	39	14	42
Pensioners	16	14	16	19	19	21	6
Overall median poverty gap %	23	35	24	35	35	30	38

Source: POLIMOD using FRS 2003-04.
Notes: Poverty rates are calculated as the number of people living in households with equivalised income below 60 per cent of the within-scenario median. The modified OECD equivalence scale is used with Before Housing Costs (BHC) incomes and the "companion "scale is used with After Housing Costs (AHC) incomes (see DWP, 2007; page 189)

Benefit "increases"

In contrast, the combination of the base case mitigated by increased benefit uprating after 20 years shows an almost distributionally-neutral effect, with an average loss of around 5 per cent of income across the whole distribution. In other words, if the other pressures on the public finances necessitated this kind of revenue gain, a balanced way of raising the revenue would be to allow the fiscal drag to occur, but to uprate benefit and tax credit rates by the factor that would result in only slow benefit erosion.

Nevertheless poverty overall would be a little higher after 20 years of Scenario B with more generous benefit uprating, than at the starting point (Table 3). While pensioner poverty would be a little lower after 20 years of this scenario, child poverty would be somewhat higher: 30 per cent compared with 27 per cent on an AHC basis and 20 per cent compared with 18 per cent on a BHC basis. Enhancing the annual rate of benefit uprating by 1.87 per cent would not be quite sufficient to prevent child poverty from rising at all but would prevent dramatic increases in child poverty on the scale implied by base case uprating.

This can be contrasted with the effect on child poverty of targeting the same amount onto payments for children. The increase in the per child payment of the Child Tax Credit that could be financed by 20 years under Scenario B - an increase of 150 per cent relative to its

value at the starting point - would have a dramatic effect on the child poverty rate, as shown in Table 3. It would fall to nearly half its AHC starting level (14 per cent compared with 27 per cent) and a third of the base case after 20 years. On a BHC basis the reduction would be to 9 per cent from 33 per cent under the base case (and 18 per cent at the starting point). Interestingly this would slightly reduce poverty rates overall but the rate for pensioners and also for working age people (not shown) would rise.

A targeted increase for pensioners could involve putting all the resources into raising the Basic State Pension. Scenario B would allow it to be restored to its 1979 value relative to earnings, increasing its starting point value by 60 per cent. This would have a very dramatic effect on the pensioner poverty rate, reducing it to 6 per cent on an AHC basis compared with 16 per cent under the scenario where the resources under Scenario B are put into benefits across the board; the same as the starting point (Table 3). This may seem surprising since low income pensioners receive the Pension Credit, which is in any case uprated by earnings. Part of the explanation lies in the fact that the increase in the Basic State Pension – an increase greater than earnings growth – would take some pensioners above Pension Credit guarantee level and part in the fact that non take-up of Pension Credit limits its effectiveness in preventing pensioner poverty. Those not taking up Pension Credit but with entitlements to the Basic State Pension would benefit from the increase in full. The next section considers this and other scenarios for pensioners, taking account of the evolution of incomes over time.

VII. THE OLDER POPULATION AND THE EFFECTS OF RECENT AND ALTERNATIVE REFORMS TO UPRATING POLICY

The analysis in this section investigates the effect of alternative uprating policies on the evolution of pensioner incomes, using the dynamic microsimulation model CARESIM. This allows us to take account of the way portfolios of income change over time, assumed constant in the preceding analysis and particularly important for understanding the medium term effects of uprating on the incomes of older people. A focus on older people is interesting for several reasons. First, older people are affected by uprating for long periods of time. In retirement, the extent to which one's income keeps pace with or lags behind the incomes of

[17] As explained later, these figures are not directly comparable with the poverty rates in the previous sections or indeed with the official Households Below Average Income Statistics. It is the comparison across age groups which is important to note at this point.

the general population is heavily dependent on how state pensions and other pensioner benefits are uprated each year. Secondly, the uprating of pensioner benefits has been changed in recent years and has also been the subject of considerable debate ever since the Basic State Pension ceased to be linked to earnings. The means-tested minimum income available to pensioners has been increased by at least earnings growth since 1999 and there is now a commitment to link the Basic State Pension to earnings from what is expected to be 2012. In addition, the 2007 Pensions Act changed the way certain parameters of the Pension Credit are uprated as a means of bringing about a structural reform to this benefit. These changes provide an interesting case study.

To understand the impact of uprating policies on the evolution of pensioner incomes, we consider first differences across age groups in the incomes of today's pensioners. Table 4 presents median incomes, poverty rates and receipt of means-tested benefits in 2006-07 by five-year age groups, as simulated by CARESIM. From the youngest to the oldest age group, there is a clear fall in income, while poverty rates and receipt of means-tested benefits increase. Seventeen per cent of those aged 65-69 are poor (BHC) compared with 42 per cent of those aged 85+. AHC poverty is lower but the trend across age groups is similar, doubling from 8 per cent amongst 65-69 year olds to 16 per cent of those aged 85 and over.[17] Nineteen per cent of the youngest age group receive Pension Credit compared with 48 per cent of the oldest. These differences could be due to individual pensioners experiencing reductions in their incomes, or to later generations of pensioners retiring on (and maintaining) higher incomes than earlier ones, or to a combination of the two.[18]

[18] A decline in income across the age groups would also be observed if those on higher income died younger than those on lower incomes. Since all the evidence suggests the opposite - richer people live longer than poorer people – this is unlikely to be an explanation. Rather, the fall in income across the ages would be more marked if there was less difference in life expectancy between rich and poor.

Table 4: Incomes, poverty rates and receipt of means-tested benefits among today's pensioners by age group in 2006-07

	Age in 2006-07					
	65-69	70-74	75-79	80-84	85+	65+
Median income (£/week)						
BHC	295	272	258	244	240	266
AHC	289	259	242	230	223	250
Poverty rate (%)						
BHC	17	23	30	38	42	28
AHC	8	11	14	16	16	12
Receiving PC (%)	19	23	31	37	48	29
Receiving CTB (%)	29	34	38	43	47	36
Receiving HB (%)	16	17	20	24	27	20
Receiving any MTB (%)	32	38	43	50	57	42

Source: CARESIM using FRS 2003-04

The results of the analysis in this section are therefore presented in two ways. First we consider the impact of policies on the incomes of pensioners who are at least 65 years old in 2006-07 as they age over the next 20 years. This helps us to gauge the extent to which individual pensioners experience changes in their income over time and the role of uprating policies in influencing the path of their incomes. Secondly we compare the incomes of today's pensioners with projections of the incomes of people of the same age in the future. For example, the incomes of people currently aged 85+ are compared with projections of the incomes of those aged 85+ in 20 years' time, where the latter group are the survivors of those currently aged 65+.

Uprating assumptions for taxes and state benefits used in the base case are those set out in Section IV including the effect of the structural reforms announced in the 2007 Budget. Assumptions about earnings and price increases are also the same as in previous sections. But we make particular assumptions about each source of primary income in order to model how the incomes of pensioners are likely to change in practice, as follows: income from non state pensions increases in line with the RPI;[19] capital holdings are assumed to remain constant in

[19] If anything, this is likely to overestimate the increase in these sources of income that pensioners receive in practice. Defined benefit private pensions tend to increase by at most price inflation and many pensioners drawing annuity-based pensions opt for annuities that remain at the same nominal level throughout retirement.

nominal terms and thus to fall in relative earnings terms; income from capital is also assumed to remain constant in nominal terms and by implication interest rates remain unchanged.[20]

As before, the base case assumptions for uprating policies amount to a continuation of current policy including the changes contained in the 2007 Pensions Act and the 2007 Budget. The alternative policies examined are:

a. The uprating policy for the Basic State Pension (BSP) and Pension Credit (and linked parameters of Housing Benefit and Council Tax Benefit) which pre-dates the Pensions Act: the BSP and the Savings Credit threshold are linked to the RPI but as in the base case the Guarantee Credit level is linked to earnings.

b. Price- linking (RPI or Rossi as appropriate) of all components of state pensions, Pension Credit and HB and CTB for pensioners except the historically frozen elements such as the capital thresholds.

c. As a. but with revenue under Scenario B used to increase the Basic State Pension as explained in Section VII.

CARESIM ages an initial sample of people aged 65 and over so these people (if they are still alive) are, for example, aged 71 and over after 6 years, and 85 and over after 20 years. So when comparing the incomes of today's older people with CARESIM's projections of the incomes of people of the same age in the future, the age groups we can analyse are limited. We therefore focus on those aged 85+ for comparisons with 20 years' time and, looking 6 years ahead, consider those aged 75+ and 85+.

The analysis is also restricted to people who were single and over state pension age in the starting year, or part of a couple where both partners were over state pension age. Income is measured a little differently from previously. It is the total income of the benefit unit rather than the household (ascribed to each person in the household) and disability/care-related social security benefits – Attendance Allowance, Disability Living Allowance and Carer's Allowance and the associated premiums in Pension Credit – are excluded from income. Nevertheless, for simplicity, in calculating poverty rates, poverty thresholds are those computed using POLIMOD and described in the preceding sections of this paper. While

[20] This is equivalent to assuming that pensioners consume all the income from their capital but do not deplete the original capital sum. No allowance is made for windfall increases in capital e.g. from inheritances.

differences in the definition of income and of pensioners, pensioner poverty rates and other results are not directly comparable with those in earlier sections or with official HBAI statistics, it is the trends over time and differences across uprating policies which are the main point of interest.[21]

The impact of uprating policies on pensioners as they age

Table 5 shows the effect of different uprating policies on pensioners as they age. Under the base case the poverty rate (BHC) amongst those who survive the next 20 years rises from just over a fifth (22 per cent) to getting on for a third (30 per cent) after 20 years. The percentage receiving Pension Credit increases from 23 per cent to 35 per cent, while receipt of any means-tested benefit rises from 35 per cent to 46 percent. Poverty rates rise a little more after the Pension Act but rates of receipt of means-tested benefits rise much less than if previous uprating policy had continued. Under pre-Pension Act policies, half of this generation of pensioners would be receiving Pension Credit after 20 years, with the proportion on any means-tested benefit reaching 57 per cent.

The "base case" and pre-Pensions Act results already incorporate the current government's commitment to earnings-uprating of the Guarantee Credit. In the context of the discussion elsewhere in this paper of the effect of the *lack* of such a commitment for other age groups, it is instructive to look at what would have been implied if the means-tested minimum for pensioners had instead remained price-linked. The results show that a return to price indexation of all but the frozen elements of pensioner benefits would contain the growth in Pension Credit receipt. After 20 years the proportion receiving Pension Credit would be slightly lower than at the start of the period (19 per cent compared with 23 per cent) and the proportion receiving any means-tested benefit would be only a little higher (37 per cent compared with 35 per cent). But this would be at the cost of a poverty rate in 20 years' time of close to one half (54 per cent BHC; 45 per cent AHC).

Going in the other direction, in contrast, spending the revenue under Scenario B on increasing the Basic State Pension would reduce poverty to very low levels and substantially diminish dependence on means-tested benefit. Poverty among this generation of pensioners would fall to 5 per cent (BHC), receipt of Pension Credit to 7 per cent and receipt of any means-tested benefit to 27 per cent.

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[21] For further discussion see Sutherland et al. (2008).

[23] Of course, if the revenue gain from fiscal drag and benefit erosion were spent on e.g. public services rather than income transfers the distribution of benefits from these services would need to be taken into account.

Table 5: Impact of alternative uprating policies on pensioners as they age: people aged 65+ in 2006-07 and alive after 20 years, relative earnings terms

		After 20 years				
	Starting point	Base case	Pre 2007 Pensions Act	Prices uprating	Spending under Scenario B on BSP	SERPS/S2P linked to earnings from 2012
Poverty rate (%)						
BHC	22	30	29	54	5	26
AHC	10	10	12	45	2	8
Receiving PC (%)	23	35	50	19	7	33
Receiving CTB (%)	32	41	47	33	24	40
Receiving HB (%)	16	17	18	16	13	17
Receiving any MTB (%)	35	46	57	37	27	45

Source: CARESIM using FRS 2003-04

The impact of uprating policies on differences in the incomes of current and future pensioners

In six years' time poverty rates and reliance on means-tested benefits among pensioners aged 75+ and 85+ would be similar to today under the base uprating policy and also under pre Pension Act policies (Table 6). In 20 years' time, poverty rates would be lower among those aged 85+ than today under each of these three uprating policies. Just over two-fifths (42 per cent) of people currently aged 85+ are poor (BHC). In 20 years' time the equivalent proportion would be 30 per cent under base case policies and a little lower under pre Pension Act policies. Receipt of Pension Credit would have fallen from just under a half (48 per cent) to 35 per cent under the base case but before the Pension Act reforms would have risen slightly.

If we were to revert to general price-uprating, poverty rates would rise even after six years. The increase would be modest for those aged 75+ (from 36 per cent to 38 per cent, BHC) but by more for people aged 85+ (from 42 per cent to 47 per cent). In 20 years' time more than half (54 per cent) of those aged 85+ would be poor under prices upratings. But as before prices uprating would reduce the proportions receiving Pension Credit and means-tested benefits in general. In contrast, spending the revenue from fiscal drag on increasing the Basic State Pension would reduce poverty rates – very substantially after 20 years – and reliance on means-tested benefits.

Table 6: Impact of alternative uprating policies: comparison of today's pensioners with those of same age in 6 and 20 years' time, relative earnings terms

		After 6 years					After 20 years				
	Starting point	Base case	Pre 2007 Pensions Act	Prices uprating	Spending under Scenario B on BSP	SERPS/S2P linked to earnings from 2012	Base case	Pre 2007 Pensions Act	Prices uprating	Spending under Scenario B on BSP	SERPS/S2P linked to earnings from 2012
Aged 75+											
Poverty rate (%)											
BHC	36	32	31	38	23	32					
AHC	15	14	13	27	8	14					
Receiving PC (%)	37	37	40	28	28	37					
Receiving CTB (%)	42	42	43	37	36	42					
Receiving any HB (%)	23	21	21	20	20	21					
Receiving any MTB (%)	49	48	49	42	42	48					
Aged 85+											
Poverty rate (%)											
BHC	42	41	40	47	32	41	30	29	54	5	27
AHC	16	16	15	36	10	16	10	12	45	2	8
Receiving PC (%)	48	48	49	38	38	48	35	50	19	7	33
Receiving CTB (%)	47	49	49	44	43	49	41	47	33	24	40
Receiving any HB (%)	27	26	26	25	25	26	17	18	16	13	17
Receiving any MTB (%)	57	56	57	51	52	56	46	56	37	28	45

Source: CARESIM using FRS 2003-04

VIII. CONCLUSIONS: CHOICES AND TRADEOFFS

Other things being equal, continuing to uprate benefits, tax credits, and direct tax thresholds as under current policies for the next 20 years would produce a very considerable improvement in the public finances, measured in relation to national income, as a result of fiscal drag and what we have called benefit erosion. Overall, the budgetary effect could be a benefit to the public finances equivalent to up to 3.6 per cent of GDP after 20 years.

But at the same time, the incomes of a considerable part of the poorer non-pensioner population would fall behind those of the population as a whole, and relative poverty would rise. For instance, in this "base case", child poverty as conventionally measured (before housing costs) would rise from 18 per cent at the starting point to 33 per cent after 20 years. Instead of eradicating child poverty, the effect of continuing current uprating policies would be almost to double it.

Ad hoc and structural reforms – enabled in part by the creeping revenue gain – can, of course, offset such gradual effects. But the analysis here suggests that such changes would have to be very frequent if they were to do so. For example, the reforms announced in the 2007 Budget can be expected to have a progressive effect, raising incomes of those in the lower income groups overall, and reducing relative poverty (Sutherland et al. 2008). However, a reform of that scale would be required every two to three years to offset the rise in relative child poverty that benefit erosion implies under current policy, and indeed every year to offset the fall in relative income for lower income groups as a whole.

Policy-makers may see fiscal drag and benefit erosion as politically painless or "stealthy" ways of improving the public finances without taxing incomes at a higher rate. This may, for instance, be seen as necessary to cope with the demands of an ageing society and a natural consequence of this is that people generally retain less relative to an average earned income. But the problem is, as demonstrated by Figure 3 , that achieving a gain to the public finances like this would <u>not</u> affect everyone in the same way: the distributional impact would be very unequal. The bottom quintile would lose proportionally more than three times as much as the top quintile. This has major implications for relative poverty, even after taking account of the way median incomes would grow more slowly than gross earnings.[23]

In reality, the tax and benefit system will not be left on auto-pilot for the next 20 years. However, structural reforms would not *necessarily* improve the distributional position. For

instance, we show in Figure 4 what would happen if the government decided to cut tax rates to offset the rise in the tax ratio otherwise implied by fiscal drag. In lower income groups net incomes would fall considerably behind average gross earnings but those with the highest incomes would actually see their net incomes rise *faster* than earnings as they gained from cuts in tax rates. In contrast – with the same overall net revenue gain to government – if benefits and tax credits were uprated annually by an amount closer to earnings growth, all income groups would see a relative reduction but this would be in roughly the same proportion to their incomes, and the rise in relative poverty would be contained.

In the main the choices made about year-to-year uprating and indexation are often invisible and their effects little noticed, but this has been far from the case for pensions policy. Section VII – looking at the prospects for cohorts of current pensioners as they age – illustrates the effects of the series of controversies and policy decisions stretching over more than twenty years that culminated in the 2007 Pensions Act. While the poverty rate (before housing costs) for today's pensioners aged 85 and older is modelled at 42 per cent, this could have risen to over 50 per cent for the equivalent group in 20 years' time, if all pensioner benefits were simply price-linked. By contrast, with the reforms now in place, with the Guarantee Credit and (eventually) the Basic State Pension linked to earnings, the poverty rate for this group would fall to 30 per cent. But the outcome of those reforms is a sharp distinction in practice between the treatment of the pensioner and non-pensioner populations.

As things stand in the UK, with the combination of high poverty rates in international terms, particularly for children, and a system largely using price-linking as a default, the consequences of leaving decisions about uprating on auto-pilot are very large, and deserving of much more open discussion than has been the case.

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APPENDIX: Base case uprating assumptions

Table A1 shows how each element of the tax and benefit system is uprated according to the base case under the application of current uprating policies and assumptions. The values of the uprating factors are shown in relation to prices and in relation to earnings. We have assumed that the Retail Prices Index (RPI) and the Rossi index move up to 2011/12 as given in the 2007 Budget Report (HMT, 2007; Table C3). These indexes apply to uprating of taxes and benefits in the following year. So, for example, the 2011/12 index will be used for uprating taxes and benefits in April 2013.[24] For the remaining 13 years of uprating (to 2026/27) we assume the same constant rate growth in RPI and Rossi as given for the final year, 2011/12: 2.75 per cent for the RPI and 2.25 per cent for Rossi. Table A2 shows the nominal value of the indexes used as the basis for the uprating of individual elements shown in Table A1.

Earnings uprating uses the change in Average Earnings up to the previous July. The specific index used in practice is the AEI LNNC.[25] However, there are no official projections or assumptions about how this will move in the future. We have made the assumption that real earnings growth is 2 per cent per year over the whole period. The resulting nominal index is shown in Table A2.

[24] The index of annual change up to the previous September is used and this is what is assumed by HMT in the price indexes shown in Table A2.

[25] http://www.statistics.gov.uk/StatBase/tsdataset.asp?vlnk=392&Pos=1&ColRank=1&Rank=-1

Table A1 Base case uprating assumptions

Tax and benefit levels and thresholds	Current uprating policy or assumption	Change after 20 years relative to Prices (RPI)	Change after 20 years relative to Earnings
• Income tax personal allowances and Married Couples allowance • Income tax thresholds and income limit for age-related allowance • National Insurance contribution lower and upper limits and thresholds • Child benefit, Widowed Parent's Allowance, Bereavement Allowance, Contributory JSA, Incapacity Benefit, Carer's Allowance, Attendance Allowance, Severe Disablement Allowance, Disability Living Allowance, Maternity pay and allowances, War Pensions • All Working Tax Credit payments, additions and disregards • Severe disability premiums on IS, HB, CTB	In line with RPI	0.00%	-32.70%
• Basic State Pension (BSP)	In line with RPI (with 2.5% minimum nominal increase) until year 7 (2012/13) then with earnings	34.59%	-9.43%
• Family element of the Child Tax Credit, Baby element of the Child Tax Credit, Child and Working Tax Credit thresholds, • Childcare element of the WTC maximum amounts • Housing Benefit, Income Support, Council Tax Benefit and Pension Credit capital limits • Earnings and other disregards in IS, HB and CTB • Winter fuel payments to pensioners	Frozen: no change in nominal amount	-42.71%	-61.45%
• Income Support, Income-based JSA, Housing Benefit and Council Tax Benefit applicable amounts (except for pensioners and children) • Non-dependent deductions and income limits in IS, HB, CTB • Council Tax second adult rebate income thresholds	In line with Rossi index : 2.25% per year	-9.29%	-38.95%
• Pension Credit Guarantee amounts (GC), Income tax age-related allowances	In line with earnings	48.59%	0.00%

Tax and benefit levels and thresholds	Current uprating policy or assumption	Change after 20 years relative to Prices (RPI)	Earnings
• Savings Credit lower threshold o Single	In line with RPI until year 3 (2008/9), then with earnings until year 9 (2014/15), then calculated from GC level and maximum payment (indexed by prices)	57.41%	5.94%
o Couple		55.46%	4.62%
• Savings Credit maximum amount o Single	According to a formula depending on the movement of the SC lower threshold and GC amounts until year 9 (2014/15) and then in line with RPI	23.66%	-16.78%
o Couple		25.04%	-15.85%
• Per child element of the Child Tax Credit	In line with earnings until year 4 (2009/10) and then in line with RPI	6.12%	-28.58%
• Minimum wage, Council Tax	In line with earnings (by assumption)	48.59%	0.00%

Note: Many rules for the uprating of benefit amounts involve rounding assumptions: typically benefits are rounded to the nearest 5p a week, the increase in tax thresholds up to the nearest £100 a year and the increase in tax allowances to the nearest £10 a year. These conventions are ignored in the uprating of the systems shown here.

Table A2 Assumptions about year-to-year percentage changes in prices and earnings

Uprating applied in:	2007/8	2008/9	2009/10	2010/11	2011/12	2012/13	2013/14 to 2026/27
RPI (a)	3.5	3.5	2.75	2.75	2.75	2.75	2.75
Rossi (a)	3.0	2.25	2.5	2.5	2.5	2.25	2.25
Earnings (b)	5.57	5.57	4.805	4.805	4.805	4.805	4.805

All changes from last year, Sept-Sept for RPI, July-July for earnings (so 2006-07 uses Sept 04-Sept 05 and July 04-July 05) (a) HMT (2007) Table C3. (b) RPI with 2 per cent earnings growth