Resolution Foundation

EMERGENCY BUDGET 2010 AND LOW EARNERS

1 Overview

In our pre-emergency Budget report on options for deficit reduction[1] we argued that any fiscal consolidation plan should present a package of measures that could be assessed against our suggested criteria of growth, fairness and sustainability. While highlighting the particular vulnerability of low earners, we contended that individual measures that disadvantaged the group might be acceptable if they were necessary for growth and for sustainability, and if they were compensated by other measures within the package.

We concluded that the least bad options from the perspective of low earners are primarily tax based – in particular taxes on wealth and on income – and that the Government should therefore explore fully the potential for raising revenue from progressive taxation. In relation to inevitable spending cuts, we argued that the Government should continue to invest in programmes – such as financial advice and skills training – that are specifically designed to help low earners maintain financial independence.

The emergency Budget published on 22 June was only ever going to provide part of the story: the details of where spending cuts will fall will not be made clear until the publication of the Spending Review on 20 October. Nevertheless, by setting out the Government's proposed consolidation path, along with the split between tax and spending and details of which taxes and benefits will be altered, the Budget provides a strong indication of how low earners are likely to be affected by deficit reduction in the coming years.

The Budget contains:

- Plans to eliminate the structural current budget deficit by 2014-15 – two years earlier than proposed by the previous administration – by increasing the size of consolidation in that year from an inherited £73 billion a year to £113 billion a year;
- Plans to achieve 80 per cent of the additional £40 billion consolidation via spending cuts, taking the overall balance of the tightening in 2015-16 to 77 per cent spending and 23 per cent tax;
- Details of £11 billion a year welfare reform savings focusing on the indexation of benefits, tax credits and public service pensions, along with reductions in bills for child benefit, housing benefit, disability benefits and tax credits;

[1] Resolution Foundation, *What's the damage: A low earner impact assessment of deficit reduction options*, June 2010: http://www.resolutionfoundation.org/

- Average real-terms cuts in the annual budgets of 'non-protected' government departments of around 25 per cent by 2014-15;
- Details of £8 billion a year net tax increases, with reductions in income taxes, employer NICs and corporation and business taxes being more than offset by increases in VAT, Insurance Premium Tax and Capital Gains Tax.

Getting to grips with the UK's deficit is inevitably difficult, and we have argued that low earners should not be entirely insulated from the pain, simply that they should not be disproportionately affected (as they have been during the economic downturn). Therefore, while the overall effect of the Budget (and earlier measures introduced by the previous and current governments) is negative, there are things to welcome:

- The increase in income tax personal allowance – with offsetting measures in the basic rate threshold and upper earnings limit – is a move designed to directly benefit low earners, providing a boost of up to £170 a year for many of the six million low earners currently paying tax at the basic rate;
- The increase in the rate of Capital Gains Tax for higher earners only is set to raise £0.9 billion a year by 2014-15 with minimal effect on low earners;
- The focus on tackling regional disparities and providing support to those parts of the country whose economies rest more heavily on public sector activity and employment guards against the likelihood that fiscal tightening will hit hardest those areas already suffering most from the recession and should boost opportunities for those low earner likely to bear the brunt of public sector job loss;

The avoidance of some potentially highly regressive measures such as increasing VAT on reduced- and zero-rated goods or increasing fuel duties is also positive. There are, however, several elements which are troubling from the perspective of low earners:

- Most basically, the decision to move more quickly to close the deficit than the previous administration proposed is something of a gamble. It is based on an assumption that slower progress would be unacceptable to investors and would therefore jeopardise the UK's long-term macroeconomic stability. However, it risks damaging the fragile economic recovery and therefore hurting those most exposed to the effects of recession – low earners. With no robust way of determining the optimal speed of consolidation, plans for deficit reduction should be made contingent on the state of the economy to ensure that recovery is not put unnecessarily at risk;
- The decision to uprate tax credits on the basis of the CPI rather than the RPI means that awards are likely to be less generous over time for the one-quarter of low earner households currently in receipt of tax credits. Similarly, the three-year freeze in the cash value of Child Benefit will have a proportionately bigger effect on low earners than on higher earners, with some members of the group not being compensated by the above-indexation increase in the child element of Child Tax Credit;

- An increase in VAT from 17.5 per cent to 20 per cent is likely to increase low earner household bills by around £400 a year on average.[2] In truth, given that members of the group already spend all of their disposable income on average, such an increase in costs is likely to lead instead to a reduction in consumption for many low earner households;
- More generally, the Budget does not appear to have favoured the use of progressive tax increases over regressive taxes and spending cuts as we recommended. For example, the VAT increase is expected to raise around £13.5 billion a year by 2014-15, but a similar amount could have been raised more progressively via some combination of increasing income tax rates, increasing the National Insurance upper earnings limit or by going further in relation to Capital Gains Tax. Similarly, the decision to achieve 77 per cent of total consolidation via spending cuts means that the overall package is likely to fall more heavily on those with low incomes than it might have.

For the first time, the Budget includes a distributional assessment of forthcoming changes in taxes and benefits.[3] This analysis suggests that, taking the measures inherited by the Government along with those announced since the election, the overall fiscal consolidation package is broadly progressive, with those in the richest 10 per cent experiencing the biggest falls in net income on both an absolute and proportional basis.

However, for practical reasons, the analysis is based on only a selection[4] of the proposed tax and benefit changes: for example, it does not include the effects of the changes to Housing Benefit or corporate taxes announced in the Budget; nor, more importantly, does it include any consideration of the departmental spending cuts due to be announced in October. Given that spending cuts are generally thought to hit those who are the biggest consumers of public services – the poor – most, inclusion might suggest that the overall package is not after all progressive. Moreover, the analysis is presented for 2012-13 only, and therefore fails to capture the escalating impact of some of the Budget measures such as changes in indexation, which will again be likely to fall heaviest on the poor.

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[2] Analysis of ONS, *Effects of taxes and benefits on household income* shows that low earners account for around 22 per cent of all VAT receipts. £400 figure is based on application of this proportion to additional revenue expected to be raised by the measure.

[3] HMT, *Budget 2010*, 22 June 2010, HC 61, Appendix A

[4] Around two-thirds of benefits and tax credits changes and the majority of direct and indirect tax announcements. HMT, *Budget 2010*, 22 June 2010, HC 61, para A.10

2 The macroeconomic picture

2.1 Economic outlook

The interim Office for Budget Responsibility (OBR) was launched by the Chancellor on 17 May, and delivered its first pre-Budget forecast on 14 June. The report set out central case forecasts for a variety of indicators, while making clear the significant uncertainty surrounding each figure. Following analysis of the measures included in the emergency Budget, the OBR has subsequently revised its macroeconomic forecasts, as shown in Table 1.

Table 1: Summary of selected OBR central case forecasts

	Outturn	Forecasts					
	2009	2010	2011	2012	2013	2014	2015
Before June Budget							
GDP							
Annual GDP growth	-4.9%	1.3%	2.6%	2.8%	2.8%	2.6%	:
Inflation							
Annual CPI growth in Q4	2.1%	2.3%	1.6%	2.0%	2.0%	2.0%	:
Annual RPI growth in Q4	0.6%	3.3%	2.6%	3.3%	3.3%	3.5%	:
Labour market							
ILO unemployment (rate)	7.6%	8.1%	7.9%	7.4%	6.8%	6.3%	:
Claimant count in Q4 (millions)	1.6	1.5	1.4	1.3	1.2	1.1	:
After June Budget							
GDP							
Annual GDP growth	-4.9%	1.2%	2.3%	2.8%	2.9%	2.7%	2.7%
Inflation							
Annual CPI growth in Q4	2.1%	2.7%	2.4%	1.9%	2.0%	2.0%	2.0%
Annual RPI growth in Q4	0.6%	3.7%	3.2%	3.2%	3.3%	3.4%	3.5%
Labour market							
ILO unemployment (rate)	7.6%	8.1%	8.0%	7.6%	7.0%	6.5%	6.1%
Claimant count in Q4 (millions)	1.6	1.5	1.5	1.4	1.3	1.2	1.1

Sources: OBR, *Pre-Budget forecast* , June 2010, Table 3.3
HMT, *Budget 2010* , June 2010, Table C2

Overall, the post-Budget forecast suggests that economic recovery will be gradual, with steady GDP growth over the forecast period matched by a steady fall in unemployment. However, there is considerable uncertainty around these figures. For instance, the OBR has suggested that there is a 60 per cent chance of GDP growth being more than one percentage point higher or lower than its central forecast in 2011. Moreover, the level of uncertainty grows with the distance from the current time period.

Direct comparison of the pre- and post-Budget central case forecasts is potentially misleading: the OBR believes that interest rates in its pre-Budget forecast would have been higher (and therefore output and employment less favourable) in the absence of expectations of the increased tightening subsequently included in the emergency Budget.

Nevertheless, Table 1 shows that the OBR expects economic activity to weaken in the near term as a result of the measures in the June Budget, with GDP growth falling from 1.3 per cent to 1.2 per cent in 2010 and from 2.6 per cent to 2.3 per cent in 2011. This reflects the

effects on aggregate demand of reduced government spending and household disposable income. In the medium term, growth is expected to be slightly stronger – growing from 2.8 per cent to 2.9 per cent in 2013 and from 2.6 per cent to 2.7 per cent in 2017 – reflecting its lower starting point.

Inflation forecasts have been revised upwards in the near-term, because of the VAT increase announced in the Budget and because of the inclusion of higher oil prices in the OBR's assumptions. In the medium term, the VAT change will work its way through the figures and spending cuts will put downward pressure on inflation, meaning that CPI inflation is forecast to return to its target of 2.0 per cent, while RPI inflation is forecast to stabilise at around 3.5 per cent.

The measures contained in the Budget are expected to increase unemployment in the period: in each year from 2012, the ILO unemployment rate is forecast to be 0.2 percentage points higher and the claimant count to be 100,000 higher than was expected before the Budget.

2.2 Public finances

Forecasts

There are a range of public sector finance measures designed to capture government borrowing and overall debt:

- Public sector net borrowing (PSNB) measures the **annual budget deficit** – the difference between government receipts and government spending.
- Cyclically-adjusted PSNB measures the **structural budget deficit**. It is the gap between government receipts and government spending that exists even when the economy is operating at its full potential. The overall public sector deficit consists of this measure plus any 'cyclical deficit' associated with operating at below-potential.
- The cyclically-adjusted current budget measures that portion of the structural budget deficit that relates to current – rather than investment – expenditure. Because investment expenditure helps to increase the future potential level of the economy, it is this **structural current deficit** that is often the focus of governments during periods of fiscal tightening.
- **Public sector net debt** (PSND) records most financial liabilities issued by the public sector less its holdings of liquid financial assets, such as bank deposits. As it is a cumulative figure, consistent annual budget deficits increase the level of PSND.

Table 2 sets out forecasts for each of these indicators presented in the March Budget and in the OBR pre- and post-Budget forecasts. As with the macroeconomic forecasts set out in Table 1, the ones presented here are subject to significant uncertainty. For example, there is a 70 per cent chance that PSNB will be more than one percentage point lower or higher than the OBR's central forecast in 2011-12. Once again, this uncertainty is higher for the more distant forecasts.

Table 2: Fiscal forecasts

Per cent of GDP	Outturn 2008-09	Est. 2009-10	Forecasts 2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
March Budget								
Public sector net borrowing	6.7	11.8	11.1	8.5	6.8	5.2	4.0	:
Cyclically-adjusted net borrowing	5.8	8.4	7.3	5.3	4.1	3.1	2.5	:
Cyclically-adjusted current budget surplus	-2.5	-4.8	-4.6	-3.4	-2.5	-1.8	-1.3	:
Public sector net debt	43.8	54.1	63.6	69.5	73.0	74.5	74.9	:
OBR central case before June Budget								
Public sector net borrowing	6.7	11.1	10.5	8.3	6.6	5.0	3.9	:
Cyclically-adjusted net borrowing	6.4	8.8	8.0	6.1	4.7	3.5	2.8	:
Cyclically-adjusted current budget surplus	-3.1	-5.3	-5.2	-4.2	-3.1	-2.3	-1.6	:
Public sector net debt	44.0	53.5	62.2	68.2	71.8	73.7	74.4	:
OBR central case after June Budget								
Public sector net borrowing	6.7	11.0	10.1	7.5	5.5	3.5	2.1	1.1
Cyclically-adjusted net borrowing	6.4	8.7	7.4	5.0	3.4	1.8	0.8	0.3
Cyclically-adjusted current budget surplus	-3.1	-5.3	-4.8	-3.2	-1.9	-0.7	0.3	0.8
Public sector net debt	44.0	53.5	61.9	67.2	69.8	70.3	69.4	67.4

Sources: OBR, *Pre-Budget forecast* , June 2010, Tables 4.1 & 4.5
HMT, *Budget 2010* , June 2010, Table C6

It is difficult to directly compare the OBR forecasts with those presented in the March 2010 Budget. While the OBR has adopted a central case approach combined with quantified uncertainty (to produce fan charts), previous HMT forecasts were based on 'cautious' assumptions – implying that actual outcomes were expected to be better than those set out in the financial reports. Nevertheless, the table shows that, pre-Budget, the OBR forecast slightly lower levels of PSNB over the period than were set out in the March Budget: its forecast of 10.5 per cent of GDP (£155 billion) in 2010–11 compared to an earlier figure of 11.1 per cent of national income (£163 billion). By contrast, its forecast for structural borrowing in 2010-11 was higher than the March Budget figure of 7.3 per cent of GDP (£108 billion), at 8.0 per cent (£118 billion), reflecting its assessment that more of the deficit was permanent in nature rather than associated with economic downturn.

As with the macroeconomic forecasts set out in Table 1, the OBR has revised its figures in the light of the emergency Budget. Table 2 shows that the efforts announced in the Budget are expected to reduce the deficit more quickly, returning the structural current account to surplus two years earlier than under the Labour government's plans. As a result, PSND is expected to peak in 2013-14, rather than 2014-15.

Fiscal rules

The Government has introduced a new fiscal mandate in the Budget, designed to guide fiscal decisions over the medium term. The Government is required to achieve structural current budget balance by the end of each, rolling, five-year forecast period: in this instance, the period ends in 2015-16. By focusing on a *structural* measure, the Government hopes to provide some flexibility in the event of further economic downturn. Similarly, by adopting a *current budget* measure, the Government intends to protect investment expenditure. There is scope to reduce the period over which balance must be achieved from five years as the public finances improve, although such timeframe shortening could affect credibility if observers feel that the target cannot be sensibly met.

The OBR will independently assess the Government's chances of meeting the mandate in each of its forecasts. At this Budget, the OBR has assessed that there is a greater than 50 per cent chance of the Government achieving its mandate one year early.

The Government has supplemented the mandate with the introduction of a specific target for PSND to be falling as a proportion of GDP at a fixed date of 2015-16. Again the OBR will assess progress over time, stating in the Budget that the Government currently has a greater than 50 per cent chance of meeting the target one year early. This target reflects current circumstances and will not apply beyond 2015-16, but the Government has said that a new PSND target will be set once public finances are on a firmer footing.

Consolidation balance

The Government has stated its preference for spending cuts over tax increases as a means of achieving fiscal balance. As set out in Table 3, 80 per cent of the annual money generated by 2014-15 as a result of plans set out since the election by the new Government is expected to be drawn from spending cuts. Once these plans are added to existing Labour government policy, the balance falls slightly to 74 per cent, rising to 77 per cent in 2015-16.

In total by 2015-16, government spending is set to be £99 billion a year lower in real terms than in 2009-10, and additional tax revenues are expected to amount to £29 billion a year, generating a total fiscal squeeze of £128 billion a year.

Table 3: Total consolidation plans over the forecast period

£billion	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Labour government policy	**0.8**	**26**	**42**	**57**	**73**	**:**
Spending cuts	0.0	14	25	39	52	:
Tax revenues	0.8	11	17	18	21	:
Spending as share of total	*0%*	*56%*	*60%*	*68%*	*71%*	*:*
Policy announced by coalition Government	**8.1**	**15**	**24**	**32**	**40**	**:**
Spending cuts	5.2	9	17	24	32	:
Tax revenues	2.8	6	7	9	8	:
Spending as share of total	*65%*	*59%*	*71%*	*74%*	*80%*	*:*
Total discretionary consolidation	**8.9**	**41**	**66**	**90**	**113**	**128**
Spending cuts	5.2	23	42	63	83	99
Tax revenues	3.6	18	24	27	29	29
Spending as share of total	*59%*	*57%*	*64%*	*70%*	*74%*	*77%*

Source: HMT, *Budget 2010* , June 2010, Table 1.1

3 Budget measures

3.1 Public spending

As Table 3 shows, public expenditure is set to be £83 billion a year lower in real terms by 2014-15. Of this, £52 billion was in the pipeline before the election and £32 billion is a product of subsequent announcements.

Of the £32 billion total, around £11 billion will be sourced from reduced welfare spending. This includes savings stemming from the adoption of the CPI for indexation of benefits, tax credits and public service pensions and from reductions in tax credit, child benefit, housing benefit and disability benefit bills. A further £3.3 billion saving is expected to result from a two-year pay freeze for public sector workforces, except for workers earning less than £21,000 a year.

Total managed expenditure

The Budget announces the path of public spending for the period until 2015-16, as shown in Table 4. While spending is set to increase in nominal terms, in real terms total managed expenditure (TME) will fall by 4 per cent over the period. Within this overall trend, public sector current expenditure (PSCE) will fall by 1 per cent and public sector gross investment (PSGI) will fall by 31 per cent.

Table 4: Total managed expenditure

£ billion	Public sector current expenditure	Public sector gross investment	Total managed expenditure
Outturn			
2008-09	564.7	65.1	629.8
Estimate			
2009-10	600.6	68.7	669.3
Forecasts			
2010-11	637.3	59.5	696.8
2011-12	651.1	48.7	699.8
2012-13	664.5	46.5	711.0
2013-14	678.6	43.3	722.0
2014-15	692.7	44.9	737.5
2015-16	711.4	46.1	757.5

Source: HMT, *Budget 2010* , June 2010, Table 2.3

Departmental expenditure and the Spending Review

The 2010 Spending Review will be published on 20 October 2010. It will follow an online engagement programme commencing on 24 June for public sector workers and members of the public.

The Spending Review will set departmental expenditure limits (DELs) for every department and the devolved administrations in the period 2011-12 to 2014-15. It will also announce plans for any savings and reforms beyond those set out in the Budget in significant elements of annually managed expenditure (AME), including social security, tax credits and public service pensions.

Within the overall envelope for DELs, the NHS and international development budgets are set to be protected. As such, average real-terms cuts in annual budgets for other

departments could be around 25 per cent by 2014-15. In reality, this average figure masks differences across departments, with some likely to experience relatively small real-terms cuts and others experiencing significantly larger reductions. According to the IFS, a decision to cut education and defence by just 10 per cent in real terms by 2014-15 would result in an average cut of 33 per cent for all other departments. By contrast, in the absence of protections for health and international development, the average cut across all departments would be 14 per cent.[5]

Benefit indexation

The Budget announces that the Government will, from April 2011, use the Consumer Prices Index (CPI) instead of the Retail Prices Index (RPI) for the price indexation of benefits and tax credits. This move is expected to save around £5.8 billion a year in 2014-15 because the CPI tends to be lower than RPI. The Government has argued that the CPI is a more appropriate measure of benefit and pension recipients' inflation experiences because:

> *it excludes the majority of housing costs faced by homeowners (low income households are subsidised separately through Housing Benefit, and the majority of pensioners own their own home outright), and differences in calculation mean it may be considered a better representation of the way consumers change their consumption patterns in response to price changes.*[6]

However, our analysis shows that low earners have faced significantly higher rates of CPI inflation than higher earners in recent years because of movements in the prices of food and fuel which make up a larger proportion of spending among those with low incomes.[7] Therefore the average CPI rate is likely to understate cost of living pressures faced by low earners and benefit-recipients.

By definition, low earners do not receive many income-related benefits, but they do receive universal benefits and are the main beneficiaries of tax credits. Therefore, while low earners will not be as disadvantaged as members of benefit-dependent households by this measure, they will be more severely affected than higher earners.

Tax credits

Working Tax Credit (WTC) is a means-tested form of in-work support. In order to receive it, a person must meet certain age and working criteria. WTC payments include a number of 'elements' to reflect different individual circumstances. These include a basic element, a couples element, a lone parent element, a 30-hour element, disability elements, 50+ return to work elements and a childcare element.

Each recipient's award is determined by adding together the various elements that they are eligible for and then reducing this if their income is above £6,420. The award is tapered above this threshold at a rate of 39 per cent: that is, for every £1 of income above £6,420, the recipient has their total award reduced by 39p.

Child Tax Credit (CTC) is paid to people with responsibility for a child or children aged under 16 or between 16 and 20 and still in full time education. As with WTC, it consists of a number

[5] IFS, *Emergency Budget June 2010: Briefing and analysis*
[6] HMT, *Budget 2010*, June 2010, HC61, para 1.106
[7] Resolution Foundation, *Low earners audit*, March 2010, Chart 85

of elements designed to acknowledge the circumstances of different families. These include a family element paid to all who are eligible and a baby addition, a child element and disability elements.

As with WTC, awards are tapered. The child element is tapered at 39 per cent for incomes above £16,190, but the family element is not tapered until incomes reach £50,000, with the withdrawal rate in this instance being £1 for every £15 income above the threshold. Those in receipt of both WTC and CTC have their awards tapered at 39 per cent if their incomes are above the threshold of £6,420.

Entitlement to tax credits is initially assessed on the basis of the previous tax year's income and current circumstances. At the end of the award period, the claimant's entitlement is ascertained by comparing income in the current tax year with that in the previous tax year. If the current year's income is lower than the previous year's, entitlement is based on the current year's, figure, and more credit will be due; If the current year's income is higher by no more than £25,000, the award is unchanged; if it is more than £25,000 above the previous year's income, entitlement is based on the current year's income less £25,000, and an overpayment will have arisen.

The Budget announces several changes to these measures:

- From April 2011, the second income threshold for the family element of CTC will reduce from £50,000 to £40,000. From April 2012, the family element will be withdrawn immediately after the child element;
- From April 2011, the first and second taper rates for all tax credits will increase to 41 per cent;
- From April 2011, the baby element will be removed from CTC.
- From April 2012, the 50+ elements will be removed from WTC;
- The toddler element, which the previous administration had planned to introduce from April 2012, has been scrapped;
- From April 2011, the level of in-year disregard will fall from £25,000 to £10,000. From April 2013, it will be reduced to £5,000;
- From April 2012, a disregard of £2,500 will be introduced in the tax credits system for in-year falls in income;
- From April 2012, the period for which a tax credit claim and certain change of circumstances can be backdated will be reduced from three months to one month.

Taken together, these various policies are expected to raise £3.2 billion a year in 2014-15. They are primarily designed to target awards on those most in need, by reducing eligibility higher up the income scale. In 2007-08, around 14 per cent of higher earner families were in receipt of tax credits, so there is definitely scope for tightening eligibility. However, some of the measures – such as the removal of various elements and the increases in taper rates – will reduce the generosity of awards for low earner recipients as well.

In particular, the decision to withdraw the family element immediately after the child element from April 2012, and to do so at a rate of 41 per cent, means that the point at which

tax credits are no longer available is likely to fall somewhere within the low earner group – thereby disadvantaging some better-off members of the group.

The more aggressive means-testing of tax credits will increase marginal deduction rates (MDRs) for all recipients with incomes above £6,420, thus reducing incentives to work and earn more for a significant number of low earners. Figures in the Budget suggest that the number of individuals with MDRs over 70 per cent will increase from around 0.7 million in 2010-11 to around 2.2 million in 2011-12.[8]

Reductions in disregards are also likely to create some difficulties for low earners by increasing the number of overpayments and subsequent demands for repayment. Similarly, the introduction of a disregard for in-year income falls will have a negative impact on those affected by removing their right to an increased payment.

In April 2011, the child element of CTC will increase from its current level of £2,300 by £150 above indexation. In April 2012, it will increase by a further £60 above indexation. This is clearly welcome news for those who are eligible, providing a significant boost to their incomes. However, the measure is in part offset by the real-terms cuts in Child Benefit that are due over the next three years: while the CTC policy is expected to cost £2.0 billion a year in 2014-15, the move in relation to Child Benefit will recoup half of this.

Child Benefit

The Budget announces that the rate of Child Benefit for the first and subsequent children will be frozen for three years from April 2011. With CPI inflation set to run at 2 per cent and above in this period, this measure will result in consecutive real-terms cuts, which will grow in magnitude over time because of compound effects.

As the benefit is universal, all households will be affected, although because the same cash amount is worth proportionately more to those with the lowest incomes, the measure will fall heaviest on those in the lower half of the income distribution. However, the increase in the child element of CTC discussed above is likely to compensate most low income households, although the tightening of eligibility discussed above means that not all low earner households will qualify for this compensation. In addition, because the take-up of means-tested benefits is less than universal, there are likely to be some households that are worse off following the combined changes.

Health in Pregnancy Grant

The Budget announces that the Health in Pregnancy Grant will be abolished from January 2011. The grant currently provides £190 for women who are 25 weeks pregnant or more and have been given health advice from a midwife or doctor. As it is a universal benefit, its removal will have the biggest impact on those with the lowest incomes, including low earners.

Housing Benefit

From October 2011, Local Housing Allowance rates will be set at the 30th percentile of local rents (instead of the 50th percentile currently) and, from 2013-14 they will be uprated in line

[8] HMT, *Budget 2010*, 22 June 2010, HC 61, Table A3

with the CPI instead. From April 2011, rates will be capped at £250 per week for a one bedroom property, £290 per week for a two bedroom property, £340 per week for a three bedroom property and £400 per week for four bedrooms or more. In addition, the ten year freeze in deductions for non-dependents will come to an end, with deductions instead being uprated in April 2011 on the basis of prices.

Other reforms include making entitlements for working-age people in the social sector dependent on family size from April 2013. Also from April 2013, Housing Benefit recipients receiving Jobseekers Allowance will have their awards reduced to 90 per cent of the original after 12 months. Finally from April 2011, Housing Benefit claimants with a disability and a non-resident carer will be entitled to funding for an extra bedroom. Taken together, the various measures are expected to save £1.8 billion a year in 2014-15.

Just 5 per cent of low earner households are in receipt of Housing Benefit: 21 per cent among those households in the social rented sector and 8 per cent among those households in the private rented sector. Therefore relatively few low earners households will be affected by the various reductions, although DWP research suggests that around half of working people who are entitled to Housing Benefit don't claim it,[9] meaning that the number of low earners who could receive an award may be considerably higher.

For those who are eligible, the reforms could cause significant difficulties, particularly for those who live in areas with relatively high rents such as London (because of the cash caps on support) and for larger families (because of the £400 cap on properties of four bedrooms and more). The increase in non-dependent deductions could also make it more expensive for younger low earners to stay in the family home. Shelter has warned that the measures could push some households over the edge into debt, eviction and homelessness.[10]

Saving Gateway

The Saving Gateway – a cash saving scheme in which every £1 saved by an account holder is matched by 50p from the Government – was due to launch in July 2010. However, the Government announced in the Budget that it was scrapping implementation, in order to save £115 million a year in 2014-15.

Eligibility for the scheme was scheduled to be based on benefit receipt, meaning that few low earners would have qualified, although those in receipt of tax credits with household incomes below £16,040 would have been able to take advantage. The scrapping of the scheme is therefore likely to affect a relatively small number of low earners. However, given the difficulties that low earners have in building savings – and the exposure to changes in circumstances that this creates – it is unfortunate that the policy has been reversed.

Support for Mortgage Interest

From October 2010, the standard interest rate used to calculate Support for Mortgage Interest payments made to homeowners who are facing arrears or payment difficulties will

[9] DWP, *Supporting people into work: the next stage of Housing Benefit reform*, December 2009: http://www.dwp.gov.uk/consultations/2009/supportingpeopleintowork.shtml
[10] Shelter England press release, "Housing benefit warning", 22 June 2010: http://england.shelter.org.uk/news/june_2010/housing_benefit_warning

be set at a level equal to the Bank of England's published monthly Average Mortgage Rate, meaning that it is likely to fall from its current level of 6.08 per cent.

Low earners who have bought properties in recent years have tended to stretch themselves, and on average have higher loan-to-values than higher earner homeowners. They are therefore more likely to want to take advantage of this scheme and will therefore be more disadvantaged by a reduction in its generosity.

Disability benefits
The Government expects to save around £1.1 billion a year in 2014-15 by introducing an objective medical assessment for Disability Living Allowance claimants from 2013-14.

State pensions and benefits
The Budget includes a commitment to uprating the basic State Pension by whichever is the highest of prices (as measured by the CPI normally, but by the RPI in April 2011), earnings or 2.5 per cent from April 2011. This measure is expected to cost £450 million extra a year in 2014-15 compared to the current arrangements. In addition, while Pension Credit is set to be increased in line with earnings, in April 2011 the standard minimum income guarantee will be increased by the full cash rise in a full basic State Pension, at an additional cost of £540 million a year in 2014-15.

While the triple guarantee is good news for low earner pensioners, the costs involved clearly need recouping via other means. Given that the basic State Pension is available to all pensioners, a significant part of the cost will be directed towards higher earners. However, while the Pension Credit increase will ensure that additional resources are targeted on those with the lowest incomes, low earners by definition tend not to be in receipt of Pension Credit.

Public service pay
The Budget announces that a two-year nominal pay freeze (a real-terms cut) will be introduced from 2011-12 for public sector workforces, except for those earning £21,000 or less who will receive an increase of at least £250 a year. Any civil servants who have not already agreed a binding pay deal will have their pay frozen from 2010-11 (again, except those earning less than £21,000 a year), and will then exit the freeze earlier of other groups. The move is expected to save £3.3 billion a year by 2014-15.

Low earners held around 1.8 million jobs in the industrial sectors of *education, health and public administration* in 2007-08, representing around one-quarter of all jobs in these areas and around one-quarter of all low earners in employment. This figure does not definitively capture the number of low earner public sector workers: it refers to jobs rather than individuals; some of the jobs recorded (e.g. private sector hospital activities) are in the private sector; and some public sector jobs (e.g. library staff) are recorded elsewhere. Nevertheless, it is a useful proxy.

It is good news for most low earners working in the public sector that the pay freeze is restricted to those earning above £21,000; although the choice of threshold means that some low earners may be affected.

Moreover, for many workers earning less than the £21,000 threshold, a £250 pay increase is still likely to represent a real-term cut because of the current level of inflation. As Table 1 shows, in 2011 the OBR expects CPI inflation to be 2.4 per cent and RPI inflation to be 3.4 per cent. As such, a £250 annual pay increase in April 2011 represents a real cut for workers earning around £10,500 and above when measured in terms of the CPI, and for workers earning around £7,400 when measured in terms of the RPI.

3.2 Taxes

Table 3 shows that tax receipts are expected to be £29 billion a year higher in real-terms in 2014-15 than they were in 2009-10. This comprises £21 billion of measures introduced by the previous administration and an £8 billion net tax contribution in the emergency Budget.

Income tax

The Budget announces that the income tax personal allowance for under-65s will increase by £1,000 to £7,475 from April 2011. In order to target the giveaway to basic rate taxpayers, there will be a corresponding decrease in the levels at which the 40 per cent higher rate of tax and the 2 per cent lower rate of National Insurance Contributions are paid. The move is expected to cost £3.9 billion a year in 2014-15, although the Government has stated that it has a long-term goal of increasing the allowance to £10,000, potentially increasing costs further.

The Budget claims that the measure will remove 880,000 from income tax altogether, and that a total of 23 million taxpayers will benefit by up to £170 a year. Among working low earners, around 1.1 million do not currently pay tax and will therefore be largely unaffected by the policy, although it should help to reduce disincentives to earn more for those near the existing personal allowance threshold. The move should be welcome for the majority of the 6.0 million working low earners who currently pay income tax at the basic rate, although some may find themselves dragged into the higher rate band by the reduction in the basic rate limit.

Having been reduced in April 2011, the basic rate limit will be frozen in 2013-14. This will increase further the tax take from higher rate taxpayers and should largely leave low earners unaffected. However, as salaries grow, an increasing number of low earners could become higher rate taxpayers as a result of fiscal drag.

National Insurance

The employer National Insurance Contributions (NICs) threshold will be increased by £21 a week in addition to indexation from April 2011. The move is designed to partially offset the 1p increase in employer NICs introduced by the previous administration, which is due to take effect at the same time, at a cost of £3.7 billion a year in 2014-15.

Although the move is intended to feed through to workers in the form of higher wages and increased employment, National Insurance is a progressive form of raising money. The need to replace the revenue via another tax rise or spending cut risks increasing the burden faced by low earners.

As part of its attempt to boost private sector employment in areas that are currently heavily dependent on the public sector, the Government intends to reduce employer NICs for a

limited period for new businesses starting-up in Scotland, Northern Ireland, Wales, the North West, North East, Yorkshire and Humber, West Midlands, East Midlands and the South West. This is likely to be good news for low earners, particularly as it is those in low paid jobs who are most vulnerable to being made redundant as part of public sector cutbacks.

VAT

The standard rate of VAT will increase from 17.5 per cent to 20 per cent from 4 January 2011, raising an expected £13.5 billion a year by 2014-15. No change is made to VAT on reduced- and zero-rated items.

The move has several potential advantages. First, it is less likely to distort incentives to work and save than a change in direct or business taxes. Secondly, it is a relatively straightforward change and is expected to raise a significant sum of money. Thirdly, by pre-announcing the increase, the Government will hope that consumers bring forward some purchases, thus helping to boost the economic recovery in 2010.

However, from the perspective of fairness, an increase in VAT tends to place a higher burden on low earners than on higher earners. Costs for low earner households are set to rise by around £400 a year on average, although many members of the group will instead be required to reduce their consumption because they already live at the edge of their means.

Insurance premium tax

In line with the increase in VAT, the higher rate of Insurance Premium Tax (IPT) will increase on 4 January 2011 from 17.5 per cent to 20 per cent, while the standard rate will increase from 5 per cent to 6 per cent.

As with VAT, IPT is an indirect tax and may therefore be expected to fall more heavily on those with the lowest incomes. However, ownership of insurance products is lower among those win the bottom half of the income distribution, meaning that the distributional impact of the increase is harder to gauge. In any event, the total amount expected to be raised via this measure is less than £0.5 billion a year, suggesting that any effect on individual households is likely to be minimal.

Business taxes

The Budget announces a series of changes to business taxes. The main rate of corporation tax will be reduced from 28 per cent to 24 per cent over the course of four financial years from April 2011. The small profits rate (previously called the small companies' rate) will also be reduced in April 2011, from 21 per cent to 20 per cent. Further changes will be made to capital and investment allowances and a levy on banks' balance sheets will be introduced from January 2011. Taken together, the effect of these measures is expected to be broadly neutral in 2014-15.

Capital Gains Tax

The Budget also announces an increase in the rate of Capital Gains Tax (CGT) from 18 per cent to 28 per cent for individuals with combined income and taxable gains above the higher rate income tax threshold. The measure has immediate effect and is expected to raise £0.9 billion a year by 2014-15.

The move is positive from the perspective of low earners as very few, if any, will be affected. There may, however, have been scope for the Government to have gone further. For example, CGT rates could have been realigned with income tax rates, although the Government has argued that Treasury modelling suggests that any increase above 28 per cent would reduce revenue gains. Alternatively, the £10,100 allowance and some existing exemptions – such as main homes, pensions and ISAs – could have been reduced or removed.

Council tax

The Government has announced in the Budget that it will work with local authorities to implement a freeze in council tax in England in 2011-12, providing a mechanism whereby authorities that commit to freezing or reducing their council tax are compensated.

The move is beneficial for low earners because the group tends to be disproportionately disadvantaged by council tax. Households are charged flat fees depending on the position of their home within eight house price bands (in England, Scotland and Wales). As a result, the tax is regressive, with those in the bottom half of the income distribution facing the highest bills as a proportion of their income. Moreover, because many benefit-dependent households have their bills partly or fully paid by council tax benefit, low earners tend to suffer the biggest proportional hits.

However, while the introduction of freeze is welcome, it does not deal with the underlying problems associated with the tax. Faced with increasing funding pressures in coming years, local authorities are unlikely to be able to maintain a council tax freeze indefinitely. The Government could instead consider replacing the current council tax structure with a more progressive ad valorem land tax or even a local income tax.

3.3 Policy measures

In addition to changes in tax and benefits rates and rules, the Budget sets out details of policy measures that could impact on low earners.

Business support

The Budget makes reference to a number of policies designed to improve business conditions, particularly for small and medium sized enterprises. For example, alongside the business tax reforms discussed above, the Government intends to establish a business forum to consult with multinational businesses on the UK's tax competitiveness. It has also announced plans to create an independent Office of Tax Simplification.

The Budget provides details of additional funding for the Enterprise Finance Guarantee, which supports lending to viable small businesses that lack sufficient collateral or the financial track record to secure a commercial loan. The Government is also creating a Growth Capital Fund to provide capital for some fast-growing SMEs, and a Regional Growth Fund in 2011-12 and 2012-13 in England to support increases in business employment and growth in areas particularly affected by reductions in public sector spending.

While such measures do not have a direct distributional impact, they are likely to be positive for low earners' employment prospects. This is likely to be particularly important during a

period of fiscal consolidation, because in the search of savings and efficiencies in the public sector it is the low paid who are most vulnerable to job loss.

Retirement age

The Government has said that it will consult shortly on how to quickly phase out the Default Retirement Age from April 2011. This will be a welcome step for low earners because it will end the legal right that employers have to terminate the employment of someone who has reached default retirement age, and should therefore allow low earners who want to supplement their pension income to continue working.

Money Guidance

The Government has asked the Consumer Financial Education Body to develop a new annual family financial healthcheck, to be introduced in spring 2011 as part of the national financial advice service. The healthcheck is expected to be an interactive tool that allows families to improve the management of their finances. Given that low earners have traditionally been less likely to have access to financial advice than other members of society – and are therefore likely to be the primary customers of Money Guidance – this additional tool is likely to be of particular benefit to the group.

29 June 2010