Briefing

Resolution Foundation

Budget 2011: the impact on low-to-middle earners

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April 2011

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Summary

Having laid out detailed plans for public spending and taxes last year, the Chancellor unveiled relatively little that was new from the household perspective in his latest Budget. However, many of the pre-announced measures are only now coming into effect, with significant consequences for millions of low-to-middle earners. Of equal importance is the acknowledgement in the Budget that the economy remains very weak, with higher inflation and lower growth than previously expected, meaning that prices will continue to rise more quickly than earnings in 2011 and 2012.

This note does four things:

- First, it considers the pre-announced tax and benefit changes taking force from April 2011 that are of relevance to low-to-middle earners.[1]
- Secondly, it provides a brief assessment of the new measures announced in Budget 2011 that are likely to have a direct impact on households in the group.
- Thirdly, it looks at prospects for real wage growth under the macroeconomic forecasts set out in the Budget.
- Finally, it uses a series of case studies to consider what the combination of these economic trends with planned tax and benefit changes will mean for typical low-to-middle earner households in the next two years.

While some households – typically those without children and those with the lowest incomes – are likely to experience modest gains as a result of the fiscal changes coming into effect in 2011-12 and 2012-13, many low-to-middle earner families with children are set to lose out as a result of cuts to tax credits and other benefits. All low-to-middle earner families risk being hit by negative real-wage effects, outweighing fiscal gains in some instances and compounding fiscal losses in others. Some of the expected impacts are set out below:

- Despite benefiting by around £47 in 2011-12 as a result of cuts to fuel duty, average earnings in low-to-middle earner households are set to fall in real-terms from £19,900 in 2009 to £18,500 in 2012.
- Around 6.9 million low-to-middle earner adults will gain up to £200 as a result of the £1,000 increase in the income tax personal allowance in 2011-12.
- A second above-inflation increase in the personal allowance in 2012-13 will benefit the remaining 6.5 million low-to-middle earner taxpayers by a further £48 next year.
- Changes in employee National Insurance thresholds and rates in 2011-12 will benefit around 5.3 million low-to-middle earner employees and reduce the incomes of around 1 million.
- A shift to uprating the employee National Insurance primary threshold in line with the Consumer Prices Index rather than the Retail Prices Index from 2012-13 will reduce the incomes of 5.9 million low-to-middle earner employees by around £6. The level of loss will subsequently grow year-on-year.
- Above-inflation increases in the child element of Child Tax Credit in 2011-12 and 2012-13 will boost the incomes of families with the lowest incomes, but an increase in the rate at

[1] Our definition of low-to-middle earner households is set out in the Appendix.

which all tax credit awards are withdrawn as income rises and cuts in the generosity of various elements, including childcare, will reduce incomes for those higher up the income distribution.

- Losses are likely to extend further down the income distribution from 2012-13.
- A three-year real-terms cut in Child Benefit payments will reduce income in 3 million low-to-middle earner households with children by an average of £50 in 2011-12, rising to £116 in 2012-13 and £151 in 2013-14.
- Around 36,000 low-to-middle earner households will be affected by the decision to remove Child Benefit from all households with a higher rate taxpayer from January 2013. These households contain 92,000 children and will lose £540 on average in 2012-13, rising to £2,160 in 2013-14.
- Taking all of these effects together, low-to-middle earner households are set to face varying levels of falling income in 2011-12 and 2012-13. Compared to a baseline of 2010-11, typical families can expect to be up to 7.5 per cent worse-off in real terms.

1 Pre-announced changes taking effect from April 2011

Since 2008, government financial statements have tended to include sizeable fiscal transfers – first from the state to the public in order to support the economy during recession, and then from citizens to the state in order to help cut the budget deficit. Many of the measures announced in recent years are only now coming into effect, producing a mix of outcomes for households. Some measures will boost the incomes of low-to-middle earner households, while others will have a negative impact. Below we consider some of the major changes taking effect from this financial year.

Income tax

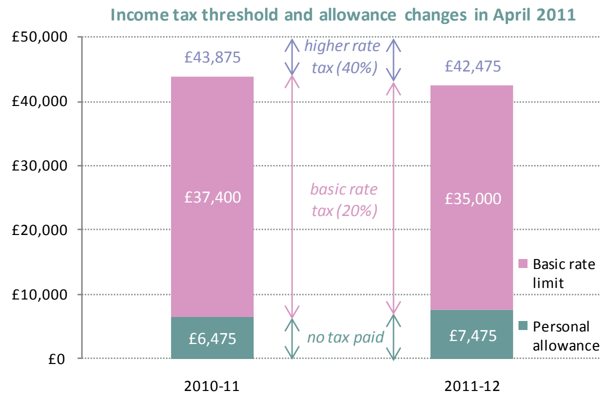


Chart 1: Income tax threshold and allowance changes: 2011-12

Chart 1 describes changes to income tax allowances and thresholds announced in the June 2010 Budget. It shows how the personal allowance (the tax free allowance available to adults aged under-65) increased from £6,475 to £7,475 on 6 April 2011, reducing most basic rate taxpayers' bills by £200 a year (20 per cent of £1,000). The Government estimates that 880,000 will be removed from income tax altogether.[2]

A £2,400 reduction in the basic rate limit (the maximum amount of income above the personal allowance on which basic rate tax is levied) from £37,400 to £35,000 means that the higher rate earnings level at which the higher rate of income tax becomes payable (the higher rate threshold) has fallen by £1,400 from £43,875 to £42,475. This shift means that the £400 gain that higher rate taxpayers would otherwise experience as a result of the personal allowance increase (40 per cent of £1,000) will be more than offset by an additional £560 charge (40 per cent of £1,400). In addition, it is expected to move 380,000 basic rate taxpayers into the higher rate bracket.[3]

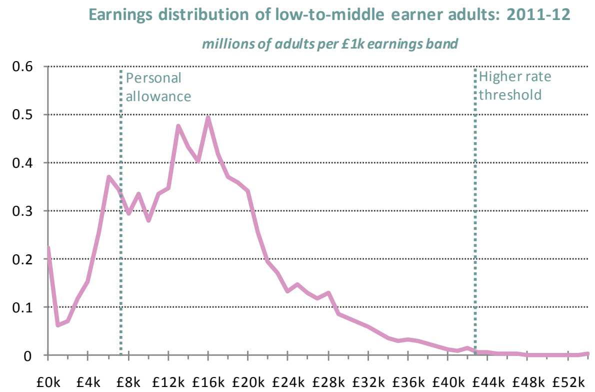


Chart 2: Earnings distribution of low-to-middle earner adults: 2011-12

Note: Earnings inflated from 2008-09 using ONS data and OBR projections for average earnings. Figures cover employees and self-employed, but exclude those low-to-middle earners not in work.

Source: RF analysis of DWP, *Family Resources Survey*

Chart 2 shows the earnings distribution of adults living in low-to-middle earner households. It shows that, **among the 8.4 million low-to-middle earner adults in employment, around 1.5 million were**

[2] HMRC, *Income Tax Rates, Rate Limits and Personal Allowances for 2011-12*

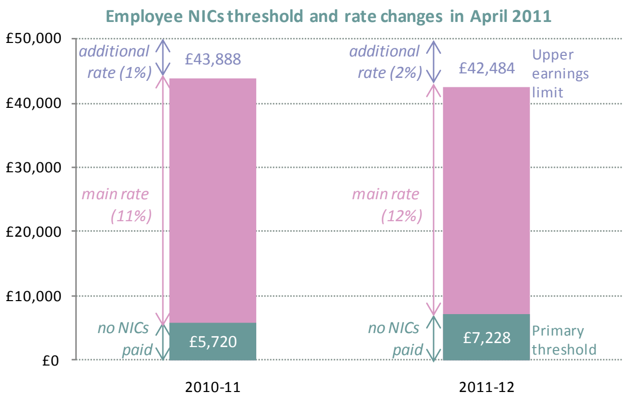
already earning too little to pay income tax in 2010-11, and will therefore not be affected by the personal allowance increase, but around 0.3 million will be removed from income tax altogether. The majority of the remainder will benefit from the move, although a small number – around 10,000 – will be moved from the basic rate to the higher rate income tax band as a result of the reduction in the higher rate threshold.

National Insurance

While the income tax changes discussed above will boost the incomes of the vast majority of working low-to-middle earners, the impact of a range of changes to National Insurance Contributions (NICs) will vary by earnings level.

In Pre-Budget Report 2008, the previous government set out plans to align the NICs primary threshold – the level of earnings at which employees become liable for NICs – in 2011-12 with the weekly equivalent of the income tax personal allowance. Based on forward plans for the personal allowance at the time,[4] this would have resulted in a primary threshold today of £6,656 (£128 a week).

Pre-Budget Report 2008 also included notice of 0.5 per cent increases in the employee and self-employed rates of NICs to take effect from April 2011. In Pre-Budget Report 2009, the government extended these rate increases by a further 0.5 per cent and increased the primary threshold by an additional £570 a year.



The Upper Earnings Limit – the level of earnings at which employees move from the main NICs rate to the, lower, additional rate – will continue to be aligned with the weekly equivalent of the higher rate threshold, and has therefore fallen by a similar annual amount (£1,404) in April 2011. Chart 3 summarises the effects of these changes on employee NICs.

Chart 3: Employee NICs threshold and rate changes: 2011-12

Taken together, these changes have the effect of removing some workers from employee NICs altogether and reducing bills for those just above the primary threshold. The maximum gain – achieved by someone with a salary of £7,228 – is £166 (11 per cent of £1,508 – the increase in the primary threshold). This gain is then reduced by 1p in each pound (because of the 1 per cent increase in the main NICs rate), so that it is entirely removed at a salary of around £23,816.

Because the additional rate is lower than the main rate, the reduction in the upper earnings limit benefits those moving from below to above the threshold – although the gain is not enough to offset the loss associated with increase in the main rate to 12 per cent. At a salary of £42,483 (just below the new upper earnings limit), an individual is £187 worse-off a year as a result of the NICs changes;

[3] HL Deb 16 Feb 2011 Vol 725 WA198
[4] The 2010 personal allowance of £6,475 was due to increase by RPI minus £130 in 2011-12.

this figure declines to a low of £43 at £43,887 (just below the previous upper earnings limit), before climbing once again at salaries above this.

Among the 7.2 million low-to-middle earner employees, 0.9 million were already earning too little to be liable for employee NICs and will therefore not be affected by the various changes, but around 0.4 million will be removed from NICs as a result of the primary threshold increase. Around 4.9 million additional low-to-middle earners will gain to some extent, because they have earnings below £23,816. However, the remaining 1.0 million low-to-middle earner employees will lose out.

Tax credits

Box 1 describes the key characteristics of the tax credit system.

Box 1: How tax credits are allocated

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 household income is above £6,420 ('first income threshold').

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 of elements – including a child element and disability elements – designed to acknowledge the circumstances of different families.

As with WTC, maximum awards are gradually withdrawn above a first income threshold. For families receiving WTC *and* CTC, the threshold is the same as above (i.e. £6,420), but for families in receipt of CTC only, the threshold rises to £16,190. All families qualifying for CTC receive a flat-cash family element. This is gradually withdrawn above a 'second income threshold'.

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 the 'income disregard', the award is unchanged; if it is more than the disregard above the previous year's income, entitlement is based on the current year's income less the disregard value, and an overpayment will have arisen.

Prior to April 2011, awards above the first income threshold were tapered at a rate of 39 per cent: that is, for every £1 of household income above £6,420 (or £16,190 for those in receipt of CTC only), the recipient had their total award reduced by 39p. The second income threshold associated with the family element of CTC was set at £50,000, with the withdrawal rate in this instance being £1 for every £15 of household income above the threshold. The income disregard was £25,000.

A range of changes coming into effect in April 2011, introduced primarily in the June 2010 Budget and Spending Review 2010, are set to boost awards for some and reduce them for others. The changes include:

- An above-inflation increase in the child element of CTC, raising the maximum annual award from £2,300 per child in 2010-11 to £2,555 in 2011-12;
- An increase in rate of withdrawal that applies above the both the first and second income thresholds to 41 per cent;
- A reduction in the second income threshold from £50,000 to £40,000;
- A reduction in the maximum costs payable under the childcare element of the WTC from 80 per cent to 70 per cent;
- Removal of the baby element of CTC – awarded in addition to the child element for families with children aged under-1;
- A reduction in the income disregard from £25,000 to £10,000;
- An extension of WTC eligibility to people aged over-60;
- A three-year freeze in the levels of the basic and 30-hour elements of the WTC; and
- In line with most other benefits, a shift in the uprating of those elements that are index-linked from the Retail Prices Index (RPI) to the Consumer Prices Index (CPI).

In addition, from April 2012:

- The family element of CTC will be withdrawn immediately after the child element, effectively withdrawing the second income threshold;
- The 50+ elements will be removed from WTC;
- A disregard of £2,500 will be introduced for in-year falls in income – meaning that tax credit awards will not be increased during the course of the year unless household income falls by more than £2,500;
- The WTC working hours requirement for couples with children will be increased from 16 hours to 24 hours; and
- 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.

From April 2013, the income disregard will fall again, from £10,000 to £5,000.

Taken together, these measures are expected to save £300 million in 2011-12, rising to £1,590 million in 2012-13 and £2,350 million in 2013-14. Because awards are contingent not just on income but also on family size, calculating average losses across all low-to-middle earner households hides much of the detail. Instead, we consider specific family circumstances in Section 4 of this note.

In general, however, low-to-middle earners are the biggest consumers of tax credits: **30 per cent of low-to-middle earner families are in receipt of tax credits, with an average annual award of around £4,000. These families account for 52 per cent of all tax credit awards and 59 per cent of the total value, meaning that significant cost cutting in this area will inevitably hit members of the group hardest**.

Child Benefit

The June 2010 Budget announced that the rates of Child Benefit for first and subsequent children would be frozen – at £20.30 and £13.40 a week respectively – for three years from April 2011, producing real-term declines in payments. The Government has estimated that the measure will save £385 million in 2011-12, rising to £1,920 million by 2013-14.[5]

The Spending Review 2010 subsequently set out plans to remove Child Benefit from families with a higher rate taxpayer from January 2013, saving £600 million in 2012-13 and £2,435 million in its first full year of operation (2013-14).

There are around 5.3 million dependent children living in 3 million low-to-middle earner households. The real-terms freeze in Child Benefit will cost affected households an average £50 a year in 2012-13. Compared to 2010-11, the average annual loss rises to £116 in 2012-13 and £151 in 2013-14.

In 2012-13, around 36,000 low-to-middle earner households with 92,000 children will contain a higher rate taxpayer. Compared to 2010-11, these households will lose £540 on average in 2012-13,[6] rising to £2,160 in 2013-14. The total savings to Government from the removal of Child Benefit from these low-to-middle earner households will be £77 million in 2013-14, representing just 3 per cent of the total anticipated savings.

Education Maintenance Allowance

The Government announced in 2010 that the Education Maintenance Allowance (EMA) would be scrapped in England from school year 2011/12. Under EMA, students aged 16-19 who had just left or were leaving compulsory education and were enrolled on an eligible course qualified for weekly awards depending on the level of their household income. In school year 2010/11, students in households with incomes below £20,817 got £30 a week (for a 39 week academic year period), those with household incomes below £25,521 got £20 a week and those with incomes under £30,810 got £10 a week.

The changes that came into effect on 1 January 2011 closed the scheme to new applicants but offered some protection for existing claimants. Students who first applied for EMA in 2009/10 will continue to receive the same weekly payment in 2011/12, while those who first applied in 2010/11 and received the maximum £30 a week will this year get £20. All other students will receive nothing, although £165 million will be made available directly to schools and colleges to distribute as they wish. As such, students in their first year in 2010/11 who received either £10 or £30 a week, will lose £390 in 2011/12, while those who received £20 a week will lose twice this amount.

Around 58 per cent of EMA recipients in 2008-09 lived in low-to-middle earner households. The scrapping of the scheme is therefore likely to be felt most particularly by members of the group. To the extent that some support remains in place, it is increasingly targeted on students from households with the very lowest incomes, meaning that low-to-middle earner students are unlikely to benefit.

[5] HMT, *Budget 2011*, Table 2.1

[6] Because the change does not take place until three-quarters of the way through the tax year.

2 New measures announced in Budget 2011

In contrast to the drama contained in recent financial statements, Budget 2011 was a quiet affair. While it confirmed that the majority of pre-announced tax and benefit changes scheduled to come into effect in April 2011 would take place, very few new measures were detailed.

In the absence of large fiscal set-pieces, the theme of the Budget was growth. The Chancellor announced a range of measures designed to encourage business investment – from reductions in the main corporate tax rate and cuts in regulation, to relatively small-scale sector-specific initiatives. Depending on their success, such measures will have an impact on economic performance, and therefore on the earnings potential of low-to-middle earners. However, there were just four announcements likely to have a direct impact on the lives of most low-to-middle earners:

- a further above-inflation increase in the income tax personal allowance in 2012-13;
- a shift to using the CPI instead of the RPI to uprate other direct tax rates, allowances and thresholds from April 2012;
- the immediate cancellation of the fuel duty escalator, the deferment of the inflation-linked increase and an additional 1 pence per litre (ppl) reduction; and
- a one year extension to the temporary conditions applying to the Support for Mortgage Interest scheme from January 2012.

Below we consider each of these measures in turn.

Personal allowance

Following the £1,000 increase in April 2011, Budget 2011 detailed a further rise in the personal allowance in 2012-13.

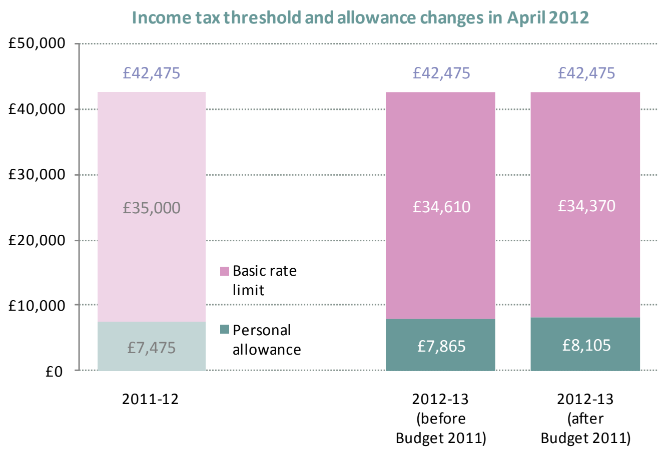


Chart 4: Income tax threshold and allowance changes: 2012-13

Chart 4 shows that, rather than rising in line with inflation (to a forecast £7,865), the allowance will now be increased to £8,105 (£240 higher than £7,865). It had already been announced that the higher rate threshold would be frozen at £42,475. The personal allowance change therefore leads to a reduction in the basic rate limit from £35,000 to £34,370 (rather than £34,610 as previously expected).

Under these changes, both basic- and higher-rate taxpayers will see their bills fall by £48 a year compared to the changes that would have happened in the absence of the Budget announcement (20 per cent of £240). **Compared to the pre-Budget scenario, around 60,000 additional low-to-middle earners are likely to be removed from income tax in 2012-13 as a result of the personal allowance increase, while the remaining 6.5 million taxpayers in the group will all gain £48.**

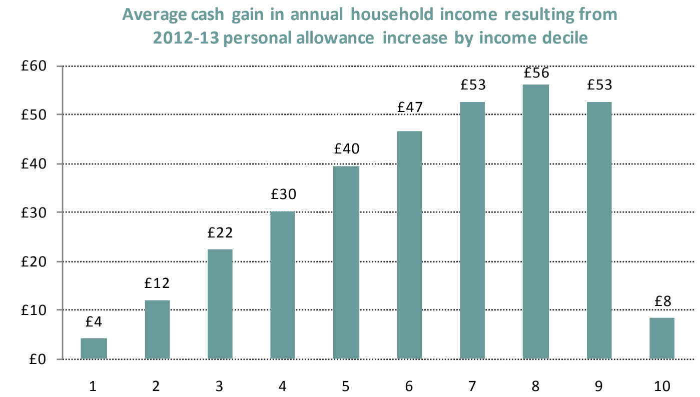


Chart 5: Distributional (cash) impact of above-inflation increase in personal allowance in 2012-13

Source: RF analysis using the ippr tax-benefit model

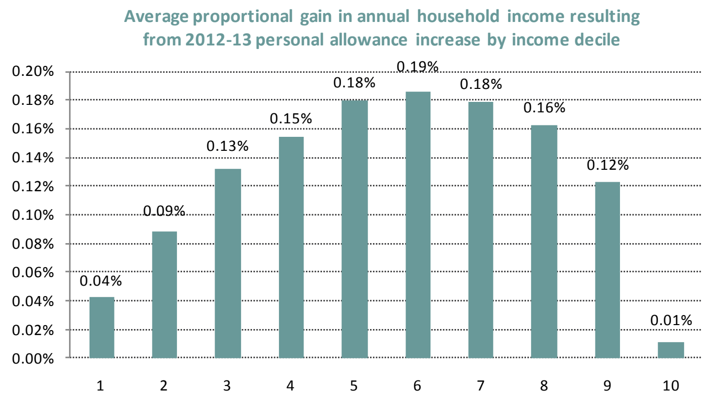


Chart 6: Distributional (proportional) impact of above-inflation increase in personal allowance in 2012-13

Source: RF analysis using the ippr tax-benefit model

Chart 5 shows the average annual increases in *household* incomes associated with the shift from the *before-Budget 2011* to the *after-Budget 2011* scenario in Chart 4, by income decile.

It shows that, across all households,[7] the biggest winners in cash terms are in deciles 7-9, with average household gains of between £47 and £56. This occurs because such deciles are more likely than those further down the distribution to contain dual-earners who both gain from the move and less likely to contain pensioners who do not benefit. Households in decile 10 gain relatively little because they contain a higher proportion of very high earners (above £100,000) who have either reduced or zero personal allowances.

Taking these figures as a proportion of household incomes, Chart 6 shows that the biggest winners appear to be households at the middle and just above – although the sums involved are relatively small.

These distributions can in part be explained by the concentration of retired households in the lower half of the income distribution. However, even if pensioner households are removed from the calculation, **two-thirds of the total expected £1,050 million cost in 2012-13[8] relates to gains by households in the top-half of the working-age income distribution. Among low-to-middle earner households the measure is worth £28 a year on average**.

Direct tax indexation

As part of the Government's commitment to eventually raising the personal allowance to £10,000, the Budget stipulated that the 2012-13 above-inflation increase discussed above will be followed by subsequent uplifts at least equivalent to RPI (until the £10,000 target is reached). However, it also announced that the underlying indexation basis for all other direct taxes would change from RPI to CPI from April 2012, although additional measures mean that increases in the employer National

[7] Because these distributions include *all* households – including pensioners – deciles 2-5 do not correspond directly to the low-to-middle earner income thresholds.

[8] HMT, *Budget 2011*, Table 2.1

Insurance threshold and age-related allowances for older people will continue to rise with the RPI for the remainder of the Parliament.

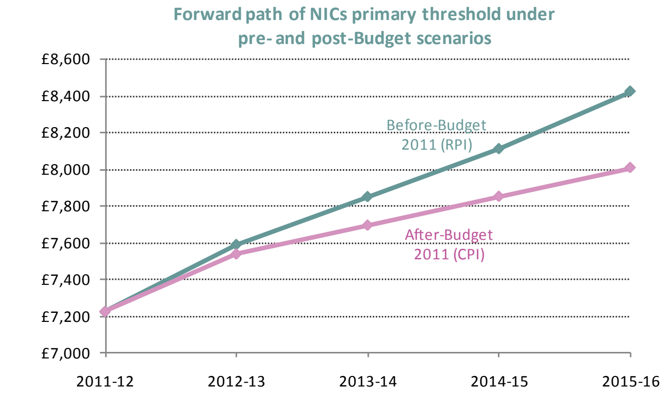


Chart 7: **Forward path for NICs primary threshold: 2011-12 to 2015-16**

Source: RF calculations based on OBR March 2011 inflation projections

Of the rates, thresholds and limits that *will* be uprated by CPI in 2012-13,[9] the most broad-based is the National Insurance primary threshold. Chart 7 shows that, based on OBR projections for inflation in September 2011, the primary threshold will increase to £7,540 in 2012-13, rather than £7,592. **The move will increase employee bills by just £6 in 2012-13 (12 per cent of £52), but the costs will grow over time as the threshold falls further behind where it would have been under RPI-indexation. By 2015-16, employees will be £50 a year worse off**.

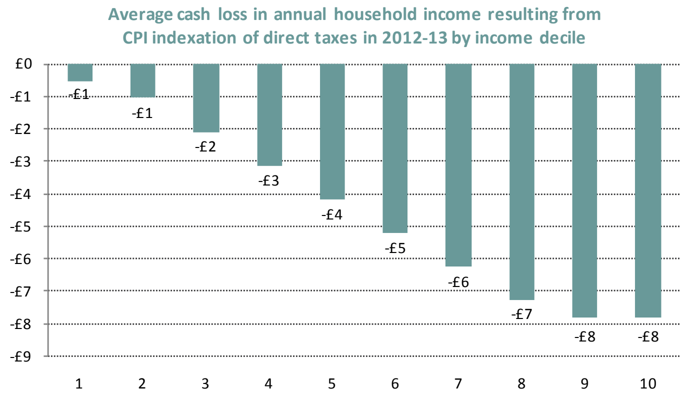


Chart 8: **Distributional (cash) impact of CPI indexation of direct taxes in 2012-13**

Source: RF analysis using the ippr tax-benefit model

Chart 8 shows the average annual decreases in *household* incomes associated with the shift from the RPI-indexation to CPI-indexation, by income decile. Unlike Chart 6, the effects relate to all of the direct tax thresholds and limits set to be affected in 2012.

It shows that the cash loss grows across the income distribution – from just £1 a year in the poorest 10 per cent of households to £8 a year in the richest 20 per cent. This distribution is again likely to reflect the higher proportion of dual-earner households at the top end of the income spectrum.

[9] Including: the Class 1 lower earnings limit; the Class 1 primary threshold; the rate of Class 2 NICs payable by the self-employed; the Class 2 small earnings exception; the rate of Class 3 NICs; and the Class 4 lower profits limit.

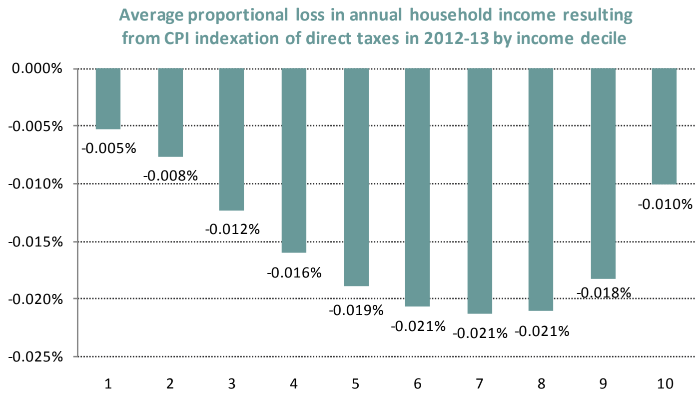


Chart 9: Distributional (proportional) impact of CPI indexation of direct taxes in 2012-13

Source: RF analysis using the ippr tax-benefit model

Taken as a proportion of income, Chart 9 shows that households in income deciles 4-9 are likely to be worst affected. While the flat-cash loss is likely to be regressive, the effect is partially offset by higher participation rates in wealthier households.

As discussed above, while the figures are tiny in 2012-13, they will grow over time, following a similar distributional pattern.

Low-to-middle earner households are set to be around £4 a year worse-off on average in 2012-13 as a result of the shift. Of the £105 million savings anticipated by the Government in the first year, around 30 per cent is set to be generated by low-to-middle earner households.

Fuel duty

Budget 2009 introduced a fuel duty escalator, which provided for an annual increase of RPI inflation plus 1 pence per litre (ppl) through to 2014-15. However, Budget 2011 announced that the escalator would be replaced by a 'fair fuel stabiliser'. Under the new system, the duty will be increased by RPI in years when oil prices are 'high' (above $75 a barrel), and by RPI plus 1ppl when oil prices are 'low' (below $75 a barrel).

In addition, fuel duty was cut by 1ppl with immediate effect. The subsequent 3.02ppl increase in the main fuel duty rate (based on RPI-only because of high prevailing oil prices) that should have fallen due in April 2011 has been deferred to 1 January 2012, with the 2012-13 increase set to be implemented on 1 August 2012.

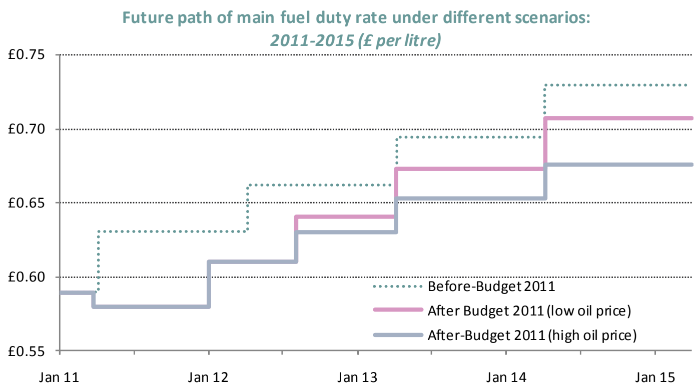


Chart 10: Forward path for main fuel duty rate: 2011-12 to 2014-15

Source: RF calculations based on OBR March 2011 inflation projections

As Chart 10 shows, these measures mean that rather than increasing to 63.02ppl in April 2011, the main fuel duty rate was reduced from 58.95ppl to 57.95ppl on 23 March 2011, and will be increased to 60.97ppl from 1 January 2012. The package is expected to cost the government £1.9 billion in 2011-12, rising to £2.1 billion in 2014-15, though this is dependent on trends in oil prices.

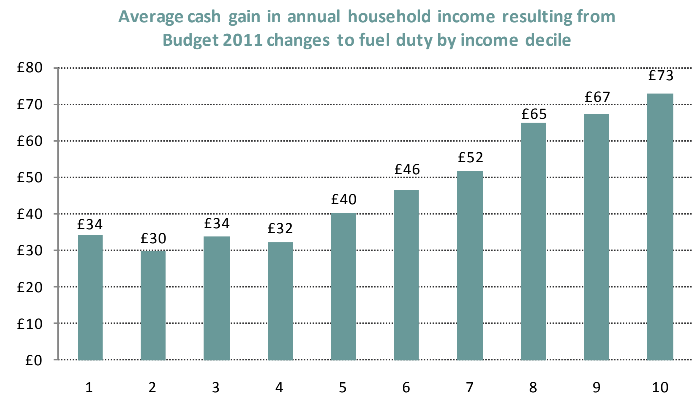


Chart 11: Distributional (cash) impact of fuel duty reduction in 2011-12

Source: RF analysis using the ippr tax-benefit model

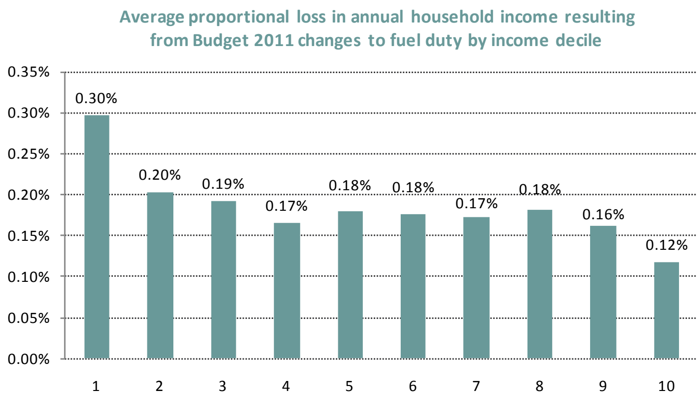


Chart 12: Distributional (proportional) impact of fuel duty reduction in 2011-12

Source: RF analysis using the ippr tax-benefit model

Chart 11 shows the average annual boost to household incomes associated with the fuel duty changes, by income decile. It shows that households in higher income deciles are set to experience the largest cash gains: £73 a year among the richest 10 per cent of households, compared with around £30 among households at the bottom end of the income distribution. The difference is likely to reflect the fact that wealthier households are likely to drive more frequently, and in bigger cars.

Chart 12 shows, however, that in proportional terms the move appears to be progressive, although there is little difference across deciles 2-9 and, as with the direct tax measures discussed above, the annual figures involved are relatively small.

Some of the financial benefits for households associated with this move will be eaten into by the increase in VAT that took place in January 2011. However, the government has estimated that the typical Ford Focus driver will be £26 better off in 2011-12 than they would have been under the previous plans for duty and VAT (i.e. retained at 17.5 per cent).[10]

Taking the fuel duty measures detailed in the Budget in isolation, low-to-middle earner households are set to benefit by around £47 in 2011-12, meaning that the group will account for around 37 per cent of the total cost. If the impact of the January 2011 increase in VAT on fuel is included, the gain experienced by low-to-middle earners in 2011-12 falls to around £15.

[10] HMT, *Budget 2011*

Support for Mortgage Interest

Support for Mortgage Interest (SMI) allows homeowners who lose their jobs and become eligible for means-tested benefits to apply for help with meeting their mortgage interest costs. Prior to January 2009, homeowners could claim after 39 weeks of joblessness and for interest payments on anything up to the first £100,000 of their mortgage. Changes brought in at that time, in response to the recession, reduced the number of weeks after which someone could claim to 13 and increased the maximum amount covered to £200,000. Budget 2011 announced that these temporary changes would be extended for a further year to January 2013, at a cost of £110 million in 2012-13.

While low-to-middle earners are, by definition, largely independent of means-tested benefits, many members of the group are vulnerable to job loss, and therefore could find themselves in the position of needing to rely on SMI. Homeowners in the group are likely to find it more difficult than higher earners to continue to meet payments under these circumstances because of their lower levels of savings, lower average redundancy payments and higher relative levels of borrowing: for example, 30 per cent of low-to-middle earner households buying a home prior to the credit crunch did so with the aid of 100 per cent mortgages, compared with 18 per cent of higher earners.

The extension of the temporary changes is therefore **welcome from a low-to-middle earner perspective, although the generosity of the scheme remains lower than it was before October 2010** because of the change introduced at that time to the interest rate paid out. Instead of receiving a fixed 6.08 per cent, recipients now get payments based on the – currently – much lower Bank of England's published Average Mortgage Rate.

3 Real wage growth

As discussed above, while pre-announced tax and benefit changes are having – and will continue to have – significant effects on household finances, the measures announced in Budget 2011 are likely to have relatively little impact. In contrast, the implications for household budgets of the updated forecasts for earnings and prices are much more substantial.

In addition to revising downwards its November 2010 forecast of GDP growth in 2011 – from 2.1 per cent to 1.7 per cent – the OBR's March 2011 outlook detailed lower expected earnings growth and higher inflation.

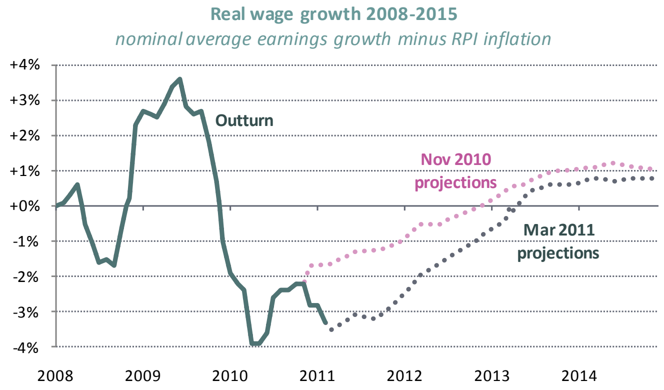


Chart 13: Real wage growth: 2008-2015

Source: OBR, *Economic and fiscal outlook*, March 2011

In November, average wages had already been falling in real terms for 12 months. The OBR's forecast suggested that they would continue to decline in the period to 2013, but that the rate of decline would fall steadily.

Chart 13 shows both that actual performance in the period since November has been much worse than expected, and that the forward path based on the OBR's latest update is more negative than previously assumed.

Chart 14 compares the current expected path of low-to-middle earner household earnings with that projected under the OBR's November 2010 forecasts. It shows that earnings are set to fall by £1,400 between 2009 and 2012, and remain £1,100 below their 2009 level at the end of the forecast period.

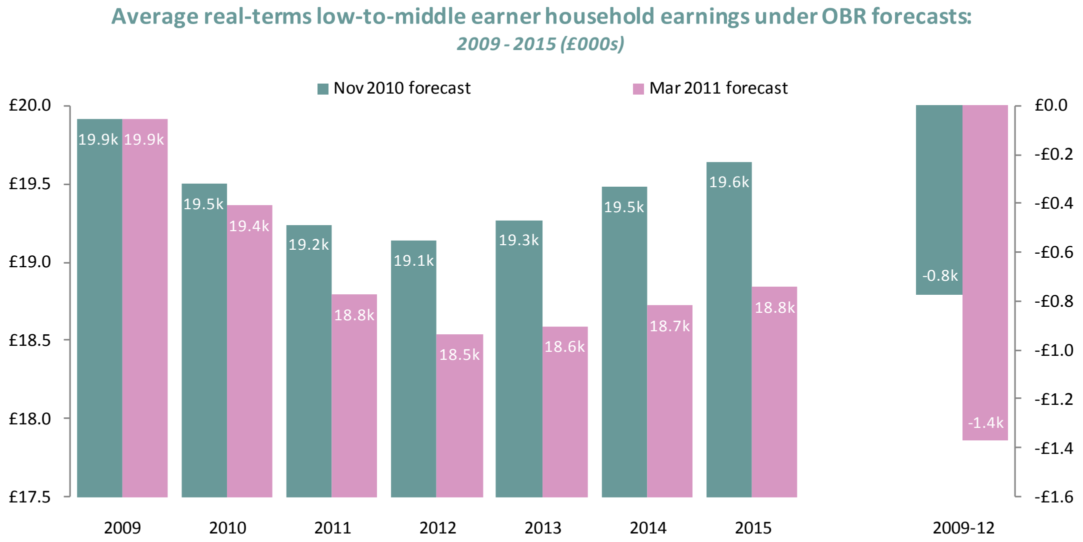


Chart 14: Real earnings growth among low-to-middle earner households: 2009-2015

Source: RF analysis of DWP, *Family Resources Survey 2008-09*;
OBR, *Economic and fiscal outlook*, March 2011

4 The prospects for low-to-middle earner households

Combining the real-wage effects set out in Section 3 with the impacts of various tax and benefit changes detailed in Sections 1 and 2 suggests that many low-to-middle earner households are likely to face significant real-terms reductions in incomes this year and next. The following case studies are based on four stylised families.[11]

Outcomes vary across household types, but each of the low-to-middle earner households considered will suffer from a significant real wage squeeze. Where relevant, incomes will be further hit by a complex range of pre-announced changes to tax credits and benefits. The new personal allowance increase announced in Budget 2011 will reduce some of these effects, but the overall picture is still negative for all of the low-to-middle earner families shown.

David & Josie

David works 35 hours a week, earning £45,000 a year. His wife Josie looks after their three year-old and their two school-age children. Table 1 sets out their position.

Table 1: Impact of earnings, prices and tax & benefit changes on David & Josie: 2010-11 to 2012-13

Three children, aged 3, 5 and 7; single-earner working 35 hours a week

2010-11 prices (£)	2010-11	2011-12	2012-13	Gain/loss from 2010-11: 2011-12	Gain/loss from 2010-11: 2012-13
Gross earnings	45,000	44,008	43,965	-992	-1,035
Income tax & NICS paid	12,140	12,147	12,118	7	-22
Post-tax earnings	32,860	31,861	31,847	-999	-1,014
Child Tax Credit	545	0	0	-545	-545
Child Benefit	2,449	2,348	1,530	-101	-919
Total household income	35,855	34,209	33,377	-1,645	-2,478
of which: resulting from tax and benefit changes				*-653*	*-1,442*
of which: resulting from Budget 2011 measures				*+0*	*+39*
Proportionate change in total income				*-4.6%*	*-6.9%*

Notes: All increases in rates and thresholds and earnings based on information in Budget 2011.
Budget 2011 measures specified here include shift to CPI indexation of direct taxation and above inflation increase in income tax personal allowance in 2012-13. Fuel duty changes are absorbed in the underlying inflation forecasts.

Source: RF calculations based on stylised family

- Because inflation is set to outstrip pay growth, David's earnings will fall by £992 in 2011-12 and by a further £43 in 2012-13 in real terms.
- On top of this drop, tax and benefit changes taking place in the next two years will reduce their household income in real terms by £653 in 2011-12 and by a further £789 in 2012-13.
- This decline comes about for two main reasons. First, the couple are no longer eligible for the family element of the Child Tax Credit (worth £545) because the threshold at which this award begins to be withdrawn has been reduced from £50,000 to £40,000. Secondly, David's status as a higher rate taxpayer means that they will lose Child Benefit from January 2013 (making them £818 poorer in financial year 2012-13).
- David's tax bill will be relatively unchanged, and Budget 2011 increases the family's income by just £39 a year in 2012-13.

[11] In order to best compare the impact of economic and fiscal changes, we assume that family circumstances do not change in any way over the period – i.e. children do not age or leave education/childcare etc. We do, however, assume that earnings grow in line with the average earnings growth forecast set out by the OBR in Budget 2011. Results are adjusted into 2010-11 prices using the OBR Budget forecast for CPI.

Taking the changes in earnings, prices and tax and benefits together, David and Josie will be £1,645 (-4.6 per cent) poorer in 2011-12 than in 2010-11 in real terms, and £2,478 (-6.9 per cent) worse-off in 2012-13.

Jack & Laura

Jack and Laura work 42 hours a week between them: Jack earns £28,000 a year and Laura earns £11,000. They have a young baby and a four year-old, both of whom are looked after by a registered childminder while Jack and Laura are at work. Their details are presented in Table 2.

Table 2: Impact of earnings, prices and tax & benefit changes on Jack & Laura: 2010-11 to 2012-13

Two children, aged under-1 and 4; dual-earners working 42 hours a week in total

2010-11 prices (£)	2010-11	2011-12	2012-13	Gain/loss from 2010-11: 2011-12	Gain/loss from 2010-11: 2012-13
Gross earnings	39,000	38,140	38,103	-860	-897
Income tax & NICS paid	8,242	7,675	7,458	-567	-783
Post-tax income	30,758	30,465	30,644	-293	-114
Working Tax Credit	4,374	1,824	1,526	-2,550	-2,847
Child Tax Credit	5,690	5,422	5,736	-268	46
Child Benefit	1,752	1,680	1,642	-72	-110
Total household income	42,575	39,391	39,549	-3,183	-3,026
of which: resulting from tax and benefit changes				*-2,323*	*-2,129*
of which: resulting from Budget 2011 measures				*+0*	*+78*
Proportionate change in total income				*-7.5%*	*-7.1%*

Notes: All increases in rates and thresholds and earnings based on information in Budget 2011.
Budget 2011 measures specified here include shift to CPI indexation of direct taxation and above inflation increase in income tax personal allowance in 2012-13. Fuel duty changes are absorbed in the underlying inflation forecasts.

Source: RF calculations based on stylised family

- Wage and price trends mean that their combined earnings are set to fall by £860 a year in 2011-12 in real terms, and by a further £37 in 2012-13.
- Tax and benefit changes will reduce the household income by an additional £2,323 in 2011-12. There will be a slight improvement in 2012-13, but the household will still have lost £2,129 compared to 2010-11.
- Changes to income tax and National Insurance will act to support their finances, boosting household income by £567 in real terms in 2011-12 and by a further £216 in 2013-14 (£78 of which is as a result of measures announced in Budget 2011).
- The main hit to the household income will instead come from tax credit changes. While the child element of the CTC (worth £2,300 per child in 2010-11) is being increased above-inflation in 2011-12 and 2012-13, the removal of the baby element of CTC (worth £545 in 2010-11), the reduced generosity of childcare support included in WTC (from 80 per cent of costs to 70 per cent) and the faster tapering of all tax credits (from 39 per cent to 41 per cent) result in a reduction of £2,818 in 2011-12 in real terms.
- Although their awards will subsequently increase by £110 in real terms in the following year, the family will still be £2,847 worse-off than in 2010-11. The freezing of Child Benefit produces a further loss.

Taking the wages, prices and tax and benefit changes together, Jack and Laura are set to be £3,183 (-7.5 per cent) poorer in 2011-12 than in 2010-11 in real terms. By 2012-13 the overall loss will have fallen slightly to £3,026 (-7.1 per cent).

Claire

Claire is a single mother with two children. Her son is 17 and is at college; her daughter is three and attends a nursery while Claire is at work. She works for 32.5 hours a week and earns £28,000. Her case is shown in Table 3.

Table 3: Impact of earnings, prices and tax & benefit changes on Claire: 2010-11 to 2012-13

Two children, aged 3 & 17 (still in education); single-parent working 32.5 hours a week

2010-11 prices (£)	2010-11	2011-12	2012-13	Gain/loss from 2010-11 2011-12	2012-13
Gross earnings	28,000	27,383	27,356	-617	-644
Income tax & NICS paid	6,756	6,497	6,387	-258	-369
Post-tax income	21,244	20,885	20,969	-359	-275
Working Tax Credit	3,464	1,872	1,668	-1,592	-1,796
Child Tax Credit	5,145	5,422	5,736	277	591
Child Benefit	1,752	1,680	1,642	-72	-110
EMAs	390	67	0	-323	-390
Total household income	31,995	29,926	30,016	-2,069	-1,980
of which: resulting from tax and benefit changes				*-1,452*	*-1,336*
of which: resulting from Budget 2011 measures				*+0*	*+39*
Proportionate change in total income				*-6.5%*	*-6.2%*

Notes: All increases in rates and thresholds and earnings based on information in Budget 2011.
Budget 2011 measures specified here include shift to CPI indexation of direct taxation and above inflation increase in income tax personal allowance in 2012-13. Fuel duty changes are absorbed in the underlying inflation forecasts.

Source: RF calculations based on stylised family

- Wage and price trends mean that her real earnings are set to fall by £617 a year in 2011-12, and by a further £27 in 2012-13.
- Tax and benefit changes coming into effect in 2011-12 will reduce her income by a further £1,452 a year in real terms.
- Changes in 2012-13 will provide a boost of £116, though she will remain £1,336 down on 2010-11.
- Her income tax and National Insurance bill will fall by £258 in 2011-12 and by a further £111 in 2012-13 (thanks in part to a £39 reduction associated with the Budget 2011 measures).
- In contrast, she will face a £1,592 reduction in WTC in 2011-12 in real terms – driven primarily by the reduced generosity of the childcare element – and a further cut of £204 in 2012-13.
- Her CTC award will increase by £277 in 2011-12 and a further £314 in 2012-13 because of above-inflation increases in the child element, but these gains will be offset by the freeze in Child Benefit and by the scrapping of the Education Maintenance Allowance for her son.

Compared to 2010-11, her household will be £2,069 (-6.5 per cent) poorer in 2011-12 in real terms in total and £1,980 (-6.2 per cent) worse-off in 2012-13.

Dan & Melissa

Dan and Melissa have no children and both work. Melissa works full-time, earning £14,500 a year; Dan works part-time and earns £5,000. Table 4 provides the details.

Table 4: Impact of earnings, prices and tax & benefit changes on Dan & Melissa: 2010-11 to 2012-13

Couple, no children; dual earners, one working full-time, one part-time

2010-11 prices (£)	2010-11	2011-12	2012-13	Gain/loss from 2010-11 2011-12	Gain/loss from 2010-11 2012-13
Gross earnings	19,500	19,070	19,051	-430	-449
Income tax & NICS paid	2,571	2,273	2,166	-298	-405
Post-tax income	16,929	16,797	16,885	-132	-44
Total household income	16,929	16,797	16,885	-132	-44
of which: resulting from tax and benefit changes				*298*	*405*
of which: resulting from Budget 2011 measures				*+0*	*+39*
Proportionate change in total income				*-0.8%*	*-0.3%*

Notes: All increases in rates and thresholds and earnings based on information in Budget 2011.
Budget 2011 measures specified here include shift to CPI indexation of direct taxation and above inflation increase in income tax personal allowance in 2012-13. Fuel duty changes are absorbed in the underlying inflation forecasts.

Source: RF calculations based on stylised family

- Differentials in wage and price growth in the next two years reduce their combined earnings by £430 in 2011-12 and by a further £19 in 2012-13.
- These losses are partially offset by a £298 gain from tax and benefit changes in 2011-12 and a further £107 boost in 2012-13. Because they are not eligible for any tax credits, this offset stems entirely from changes in income tax and National Insurance. Of the gain in 2012-13, £39 flows from Budget 2011 measures.

Overall, however, **the fall in real wages will dominate, meaning that their household income will be £132 (-0.8 per cent) lower in real terms in 2011-12 than in 2010-11. Despite some improvement, they will still be £44 (-0.3 per cent) poorer than in 2010-11 in 2012-13**.

Conclusion

Budget 2011 is likely to have limited effect on low-to-middle earner household finances. Fuel duty cuts provide a small immediate boost and the increase in personal allowance planned for 2012-13 will offer further support. A shift to uprating direct tax thresholds and allowances in line with the CPI rather than the RPI from next April will act in the opposite direction – though it is likely to take a number of years before the move has a noticeable effect on household budgets. In contrast, pre-announced changes to taxes and benefits and trends in real-wages are set to have significant effects on members of the group, with typical low-to-middle earner households facing overall reductions in incomes of up to 7.5 per cent.

Chart 15 summarises the changes affecting each of the four stylised families considered in this note. In each instance, gains and losses are separated by real-wage effects, pre-announced tax and benefit effects and Budget 2011 effects. It highlights the fact that even households that appear to benefit from fiscal changes this year and next are likely to lose out overall, because of the impact of falling real wages. The real-terms cuts in tax credits faced by many households are therefore likely to compound an already worsening financial situation. While each of the households are set to benefit slightly from the changes announced in Budget 2011, the magnitudes of the gains are insufficient to improve overall incomes in relation to the 2010-11 baselines.

Chart 15: Real-terms change in household incomes from 2010-11 baseline for stylised low-to-middle earner households

Notes: All increases in rates and thresholds and earnings based on information in Budget 2011.
Budget 2011 measures specified here include shift to CPI indexation of direct taxation and above inflation increase in income tax personal allowance in 2012-13. Fuel duty changes are absorbed in the underlying inflation forecasts.
For details of ages/circumstances of children and individual earnings levels, see detailed case study descriptions above.

Source: RF calculations based on stylised families.

Appendix: defining low-to-middle earners

From a *conceptual* perspective, we define low-to-middle earner households as including those which are squeezed by the workings of the mixed economy: too poor to be financially comfortable, but too rich to qualify for substantial state support. From an *analytical* perspective, we consider the group to include those households with below-average incomes that remain largely independent of state support. In capturing the group statistically, we adopt a three-stage process, filtering on the basis of *age*, *income* and *benefit receipt*.

First, we remove retired households from the overall population. Significantly reduced incomings and outgoings mean that many of the pressures faced by households at retirement are of a very different nature to those experienced during working lives. Therefore, while we remain interested in the experiences of older households, we define the group in most instances in relation to working-age households.

Secondly, we filter on the basis of household income. We first *equivalise* gross incomes to weight for differing household sizes and compositions. This matters because low-to-middle earners are in part defined by the fact that their living standards are squeezed and, for any given level of income, a household of five adults is likely to achieve a lower standard than a single-person household. The equivalisation process takes account of such differences by inflating the incomes of smaller households and deflating the incomes of larger ones.

We next rank the working-age households on the basis of their equivalised incomes and separate them into ten equally sized deciles (where decile 1 has the lowest income). We use median income – the boundary between deciles 5 and 6 – as the upper threshold of the group. At the lower end we create a threshold at the boundary between deciles 1 and 2. We do this in part because it represents the approximate level of earnings associated with working full-time at the minimum wage, and in part because decile 1 often produces unusual results due to the large number of households within it that have temporarily low incomes or incomes that come neither from employment nor the state.

Therefore, at this stage, the low-to-middle earner group comprises all of those working-age households with equivalised gross incomes in deciles 2-5 of the working-age income distribution (£12,000 - £30,000 for a couple with no children). For simplicity, we refer to those households with above median incomes as *higher earners*, while those households with the lowest incomes are classified as being *benefit-reliant*.

Thirdly, we filter out all those households that receive more than one-fifth of their household income from income-related benefits,[12] moving them to the benefit-reliant group. The specification of *income-related* means those in receipt of universal benefits such as Child Benefit are not excluded from the group. Tax credit receipts do not count towards a household's total level of income-related benefit because of their definition not as benefits but as a negative tax for those on low-to-middle incomes.

[12] Includes Council Tax Benefit, Housing Benefit, Pension Credit, Income Support, Lone Parent Benefit Run On, Job Grant, Income Based Job Seekers Allowance, Income Related Employment and Support Allowance, Maternity Grant, Funeral Grant, Community Care Grant, Return to Work Credit, Work-related activity premium and Child Maintenance Bonus

The Resolution Foundation

The Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low-to-modest incomes – who we refer to as low-to-middle earners (LMEs) – by delivering change in areas where they are currently disadvantaged. We do this by:

+ undertaking research and economic analysis to understand the challenges facing LMEs;
+ developing practical and effective policy proposals; and
+ engaging with policy makers and stakeholders to influence decision-making and bring about change.

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