What's the damage?

A low earner impact assessment of deficit reduction options

June 2010

Contents

Executive summary

This report considers what options the new Government has to cut the public sector deficit, and the impact that these options might have on the UK's 7.2 million low earning households. It argues that:

- The size of the structural deficit means that fiscal consolidation is inevitable and necessary. This process must be undertaken with great care, given the potential trade-off between securing economic recovery and reducing public sector activity. The pressure for a clear and credible plan, backed by a broad-based mandate, needs to be balanced with the need for some flexibility to respond to wider economic circumstances.

- The scale of the task means that both tax rises and spending cuts are inevitable. Any plan must present a *package* of measures that can be assessed against our proposed criteria of fairness, sustainability and impact on growth. The distributional impact of any specific measures can only be fully understood by working out the *combined* impact of changes to taxes and state spending on households and individuals.

- In addition to increasing tax rates and making spending cuts, reducing the deficit in a sustainable way will require more fundamental reform of current systems of taxation, welfare and public service delivery.

The Resolution Foundation works to improve outcomes for low earners, and so this report takes an in-depth look at the potential impact on this group of specific options to cut the deficit. We define low earning households as those with below median income which remain largely independent of means-tested benefits. Looking specifically at the situation of these households, and drawing on our earlier work, we argue here that:

- Even before the recession, low earners' economic independence was fragile. As a group they have become poorer relative to both higher earning and benefit-dependent households over the last thirty years.

- The economic downturn has further exposed low earners. Our analysis shows that they have suffered more during the recession than other groups – with greater risk of job loss and drops in income, and with fewer safety nets such as savings or insurance.

- The way in which the deficit is cut could compound this vulnerability. Without careful targeting, an approach that shelters the rich in the name of growth and protects the poor in the name of fairness risks asking low earners to once again bear the brunt of adjustment.

At the core of this report is an impact analysis of how individual changes to tax regimes and spending cuts may hit low earning households. We rate each change on a spectrum from '*low earners not affected/affected less than other groups*' to '*low earners significantly affected/affected more than other groups*'. The purpose of this exercise is to highlight those measures which have particular bearing on the low earner group – not to rule them out but rather to argue that if these measures are adopted, their disproportionate impact will need to be counter-balanced elsewhere.

Over the last few months there has been a great deal of debate about the most appropriate ratio between spending cuts and tax rises. It will be very hard to tackle the deficit without making changes to some of the taxes with the highest yields (e.g. income tax, VAT) or to the largest spending budgets (e.g. social protection, health) but as this report shows, different measures will have a more or less progressive outcome depending on how they are implemented.

In general, low earners are hit harder than higher earners by spending cuts than they are by changes to taxes, but the details matter. For example:

- Raising the income tax personal allowance will help the six million low earners who pay tax at the basic rate, but not as much as higher earners – who will benefit disproportionately more from an increase in tax-free earnings – unless additional measures are taken to target this change.

- While indirect taxes such as VAT are more regressive than direct taxes, we show here that increasing the standard rate of VAT would hurt low earners less than increasing the reduced rate of VAT that applies to domestic fuel and power, or introducing VAT to items that are currently zero-rated.

- Taxing universal benefits achieves similar outcomes to increasing means-testing. However it has much less of a negative impact on low earning households, as taxing benefits primarily reduces the value of universal benefits to higher earners.

By definition, low earners live on the cusp of state support. Therefore great care must be taken to ensure that those cuts that are considered necessary do not hit low earners time and again. For example:

- Sharpening tapers on existing benefits and tax credits, or introducing means-testing on those benefits that are currently universal will hit this group hardest.

- Introducing or extending user-charging for public services will also fall hard on low earning households ineligible for exemption.

Intelligent cutting will require Government to avoid the temptation to 'salami slice' budgets by cutting equally across all departments in the name of simplicity – such an approach risks hitting poorer groups in society hardest, given the higher value of public services and benefits to these households. Instead we call for a zero-based review that identifies priorities in each area of public expenditure and then assesses Government effectiveness against each of these priorities. Such an approach would build on the already successful model that has been piloted locally through the Total Place programme.

Clearly there are no pain-free solutions. But the least bad options from the perspective of low earners are primarily tax-based – in particular taxes on wealth and on income. This report therefore argues that it will be important that government fully explores the potential for raising revenue from progressive taxation, to ensure that higher earners carry their share of the burden.

In addition, while making tough calls on cuts, 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.

This report offers an analysis of the potential impact of many of the ideas floated by think tanks and others on low earning households. We hope that it provides a useful resource to help policy makers at all levels of government and others understand the trade-offs involved as they embark on bringing down the highest level of borrowing the UK has experienced since the second world war.

Introduction

The Resolution Foundation is an independent research and policy organisation. Our goal is to improve outcomes for low earners by delivering change in areas where this income group is currently disadvantaged. We do this by undertaking research and economic analysis to understand the challenges facing low earners, developing practical and effective policy proposals and engaging with policy makers and stakeholders to influence decision-making and bring about change.

In November 2009, we published *Closer to Crisis?*[1] which explored the impact of the credit crunch and economic downturn on UK households and concluded that low earners were more at risk of being hit by the recession than members of other income groups. We noted that the exposure faced by low earners was a product of their vulnerability to labour market shocks, their relatively poor pre-crisis financial health and their limited housing options. We also highlighted the risk that low earners would once again be the biggest losers during any future period of fiscal tightening designed to restore public finances to balance, because of their position on the cusp of state support. This report explores that issue in more detail.

Government borrowing has grown substantially since the start of recession in 2008, and public finances are expected to remain in deficit for a number of years. The gap between government spending and tax revenues is due in part to cyclical effects associated with the downturn, such as higher unemployment benefits and reduced tax revenues. However, much of the increased borrowing reflects more permanent structural effects associated with the reduction in the UK's potential output. Therefore economic recovery alone will not reverse these fiscal deficits, meaning that some form of fiscal consolidation is necessary.

Over the past 18 months, much discussion has taken place on this topic. A variety of authors have presented details of the size and causes of the deficit, along with cases for differing adjustment trajectories and balances. The arguments are well-rehearsed, so this paper does not spend long dwelling on them – although for the purposes of context, some discussion is included.

Instead, this report considers in detail some of the specific ideas for cutting the deficit floated by think-tanks, academics, politicians and others – from the perspective of low earners. To date, assessments of deficit-reduction proposals have tended to emphasise the need to both protect the most vulnerable from spending cuts and avoid harming growth by over-burdening the rich with tax increases. While both of these concerns are appropriate, such a narrative risks overlooking low earners.

---

[1] Resolution Foundation, *Closer to Crisis?* November 2009

We do not attempt to assess directly the impact on the group of policies outlined either by political parties prior to the election or by the new coalition Government since, because effects depend on the overall package of adjustment adopted and we do not yet have enough detail. That is, it would be disingenuous to make a judgement about how low earners are going to fare based simply on one aspect of announced tax or spending plans, because what is given with one hand is often taken away with the other. Rather, this report sets out an objective impact assessment of a wide range of proposals in order to provide policy-makers with an understanding of the implications of including such measures in the final adjustment package.

The report is structured as follows:

- Section 1 presents the economic context, setting out the size of the deficit and prospects for economic recovery;
- Section 2 provides more detail about the low earner group, explaining how we define it and why it deserves special consideration during a period of fiscal consolidation;
- Section 3 considers the process of tightening – weighing arguments about timing, pace, balance and methodology; and
- Section 4 analyses some specific options for closing the deficit, across the themes of tax, welfare and public services, and assesses the implications of each of these on low earners.

Conclusions are set out at the end of the report, while a summary of the findings from Section 4 are presented in the Appendix.

1. Economic context

1.1 Credit crunch and recession

The period from 1992 to 2007 was characterised in the UK by low interest rates and low inflation. Similar conditions around the world led some economists to argue that economic volatility was at an end and a new period, which they dubbed ‘the great moderation’, had begun. However, the speed with which problems in global credit markets in 2007 and 2008 spread to real economies around the world, exposed the fact that much of the preceding decade’s economic growth had been built on unstable foundations. Growth in the UK was particularly fuelled by increased household borrowing and a prolonged housing boom. The resulting credit crunch helped push the UK into recession in Q2 2008.

The credit expansion that underpinned this period of stability in the UK and other developed economies was in part a function of global macroeconomic imbalances. Large persistent current account deficits in developed economies were matched by surpluses in emerging economies, most notably China. While the surpluses experienced by oil-exporting economies were created by rapidly rising crude oil prices, surpluses in many Asian countries were driven by high savings rates and the competitive nature of their exports. Faced with a perceived lack of trustworthy domestic saving funds and in an attempt to avoid another currency crisis, firms and citizens in China and elsewhere opted to hold foreign assets. The large-scale purchase of developed economies’ government bonds drove a reduction in long-term real interest rates around the world.

The apparent shift to a long-term stable macroeconomic environment boosted demand for, and supply of, credit in developed economies and encouraged banks to take on more credit risk by providing higher loan-to-income ratios, extending credit to the sub-prime sector and introducing increasing numbers of complex financial instruments employing leverage. Rising asset prices, particularly residential properties, made the credit boom appear affordable and partially hid the degradation of credit standards. At the same time, cheap exports from the emerging economies helped maintain low levels of inflation.

However in 2007 and 2008, rising defaults on US subprime mortgages spilled across global financial markets, reversing the cycle of rising asset prices and credit quality. Complex securitisation markets broke down and confidence in the financial system disappeared as it became apparent that banks’ balance sheets and asset portfolios were suffering from fundamental structural weaknesses. In common with other economies around the world, the UK entered recession.

1.2 Prospects for recovery

1.2.1 Output

Chart 1 shows that, having first fallen in Q2 2009, UK output declined for six quarters in total, making it the longest recession since the start of quarterly records in 1955. It was also the deepest since the second world war, with GDP falling by 6.2 per cent over the course of the downturn.

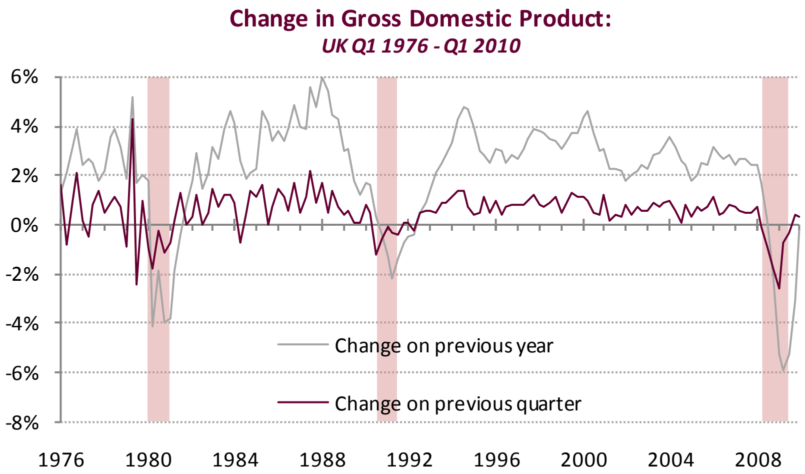


Chart 1: Change in GDP: UK 1976-2010
Source: ONS Time Series IHYQ & IHYR

Although economic output returned to growth at the end of 2009, indicators remain someway below pre-crisis trends. Chart 1 shows that output grew by 0.4 per cent in Q4 2009 and by just 0.3 per cent in the following quarter. Concerns persist that the coming months will follow the pattern of previous post-financial crisis recession recoveries by being sluggish at best and possibly even stalling altogether, with the UK suffering periodic losses of momentum and perhaps slipping back into recession.

Many of the improvements observed in the second half of 2009 in relation to output, trade, labour market conditions and housing are yet to be consolidated, and a worsening of the position in any one of these areas could jeopardise recovery in the others. For example, while labour market flexibility has contributed to lower-than-expected increases in unemployment, the corollary is that the recovery may produce equally lower-than-expected growth in employment because of spare capacity within firms, which in turn would have implications for consumer spending.

Commentators disagree on whether growth can be expected to return to trend in the short- to medium-term and on what level of growth will be sustainable in the long-term.

Those anticipating a strong recovery point to the tendency of deep recessions to produce strong bounces; at the very least there is likely to be a natural increase in output as firms engage in inventory restocking following a period in which they have drawn-down existing stocks rather than spend on new production. The relatively low level of collateral damage associated with this downturn in relation to unemployment, repossessions and insolvencies suggests that the private sector is well placed to return to growth, a position which is supported by indicators showing improved consumer and business confidence. Ongoing monetary looseness may also help, with low interest rates encouraging business and consumer spending and growth in asset (houses, stocks etc) prices. Trade growth should receive a boost from depreciation of sterling combined with the recovery in world demand, particularly in the US. Taken together, optimists suggest that these factors can help produce a self-reinforcing recovery.

However, those expecting a weaker recovery highlight a number of major headwinds in the domestic and international arenas.

Domestically, the persistence of inflation relative to the depth of recession suggests the UK has suffered a big permanent fall in productive capacity, and falling government investment in structural areas such as education and infrastructure during a period of fiscal tightening is likely to reduce potential future output. The end of government stimulus will reduce demand at the same time as continued household deleveraging and precautionary saving constrains consumer spending. Factors which supported consumer spending in previous recovery periods – falling interest rates, the opportunity to draw down on savings and strong growth – will be absent. Instead, commodity (fuel and food) price inflation driven by growing industrialisation in emerging markets is likely to produce deteriorating conditions by pushing up interest rates. In addition, bank balance sheet adjustment and ongoing tight credit conditions have implications for consumer and business spending. This should be a particular issue for SMEs, which are less likely than bigger firms to utilise corporate bond and equity markets.

Internationally, there are a number of factors which may damage growth among the UK's trading partners. A move towards synchronised fiscal consolidation will limit global demand, and Chinese efforts to curtail domestic asset bubbles by limiting bank lending within the country could have a big effect on all trading nations. The risk of contagion spreading the euro-zone crisis beyond Greece, could be particularly damaging for the UK's biggest trading partners in the EU, while the fall in value of the euro reduces the currency advantage the UK might have been expected to enjoy. Global trade may also suffer if some countries respond to growing unemployment by resorting to policies such as protectionism. While all of these factors could limit international demand for UK goods, the small size of the export sector in this country and the high proportion of intermediate imports used in the production of UK exports, mean that strong export-led recovery is unlikely in any event.

What is clear from these conflicting outlooks is that economic prospects are highly uncertain and will depend as much on global macroeconomic conditions as on domestic policy. It is also worth noting that recovery in the UK is likely to vary by region and by industrial sector, meaning that different groups will face quite different outlooks.

This uncertainty over the strength and pace of recovery is reflected in the different forecasts made regarding UK GDP growth in the past few months. Budget 2010 set out growth forecasts of:

- 1 per cent to 1.5 per cent in 2010;
- 3 per cent to 3.5 per cent in 2011; and
- 3.25 per cent to 3.5 per cent in 2012.[2]

These forecasts are slightly lower than those presented in PBR 2009,[3] reflecting a weaker outlook for the UK's largest trading partner, the euro area. Despite this downward revision, the 2011 forecast set out in the Budget remains at the top end of the independent forecasters' range of 0.9 per cent to 3.4 per cent, and significantly higher than the average 2.1 per cent.[4] The new Office for Budget Responsibility, established by the coalition Government, is likely to revise these forecasts as part of the 22 June emergency Budget.

1.2.2 Inflation and interest rates

Budget 2010 also noted that CPI inflation will remain above target in the short-term due to base effects associated with the VAT change and fuel price trends.[5] Increases in the cost of oil and depreciation of sterling are expected to provide further upward pressure in 2010, but this will be more than offset by the lagged effect of the large degree of spare capacity in the economy. As such, the Budget reported that inflation is expected to weaken to the target of 2 per cent by the end of 2010, before falling

[2] HM Treasury, *Budget 2010*, March 2010, Table B.8
[3] HM Treasury, *Pre-Budget Report 2009*, November 2009
[4] HM Treasury, *Budget 2010*, March 2010
[5] In December 2008, prices fell on a monthly basis due to a sharp fall in petrol prices, the temporary reduction in the VAT rate to 15 per cent and significant retail discounting in the period prior to Christmas. By contrast, in December 2009, petrol prices were steady, VAT remained at 15 per cent and retailers discounted by less than in the previous Christmas period. Therefore, while prices in December 2009 rose only moderately on a monthly basis, they were significantly higher on an annual basis.

still further in the first half of 2011. It is only expected to return to target by the end of 2012.[6]

Once again there are a number of factors which mean that these forecasts are, according to the Bank of England, “highly uncertain”.[7] Most obviously, there is uncertainty over the extent to which slack will remain in the economy – associated with the timing and strength of the recovery. The extent of the permanent damage done to UK supply capacity by the economic slowdown (in terms of reduced investment or workers leaving the labour market for example) is also unclear. The impacts of higher import costs on businesses, movements in exchange rates and the potential for further commodity price changes add further uncertainty.

The Bank’s official Bank Rate will continue to be set at a level deemed appropriate for maintaining inflation at close to the 2.0 per cent target. The Bank has forecast, based on forward market interest rates, that the rate will increase slowly from its current level of 0.5 per cent in late-2010, reaching 2 per cent in early-2012 and 3.2 per cent by mid-2013.[8]

1.3 Public finances

1.3.1 Size of the problem

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.
- Any portion of the structural deficit used to finance public investment is considered acceptable because it helps to increase the future potential level of the economy. Therefore, in estimating the size of the **structural current deficit** that needs to be the focus of government concern, the figure for public sector net investment (PSNI) is removed from the cyclically-adjusted PSNB figure.
- **Public sector net debt** (PSND) records most financial liabilities issued by the public sector less its holdings of liquid financial assets, such as bank

[6] HM Treasury, *Budget 2010*, March 2010
[7] Bank of England, *Inflation Report*, May 2010, pp38-48
[8] Ibid, p43

deposits. As it is a cumulative figure, consistent annual budget deficits increase the level of PSND.

Table 1 records changes in each of these measures in the period since 2006-07, along with pre-election Treasury forecasts for the period to 2014-15. It shows that the annual budget deficit amounted to 10.3 per cent of GDP in 2009-10, equivalent to £145 billion. This represents the highest level of borrowing as a share of national income since WWII. Treasury forecasts show the deficit rising still further in 2010-11, to £156 billion, with the reduction in borrowing associated with the removal of fiscal stimulus expected to be more than offset by an increase in borrowing linked to ongoing recessionary impacts on tax receipts and benefit payments.

Budget 2010 put the structural deficit at 8.4 per cent of GDP in 2009-10, equivalent to around £118 billion. This reflects the Labour Government's assessment that the financial crisis and recession had both permanently damaged the productive potential of the economy (with implications for government receipts) and permanently reduced long-run price levels (with implications for receipts in relation to asset prices and for pre-arranged public spending relative to nominal national income). The structural deficit was forecast to fall to 2.5 per cent of GDP by the end of the period, equivalent to £35 billion in 2009-10 prices.

Once investment is factored in, the structural hole (the annual structural current budget deficit) implied by the Treasury's estimates for 2009-10 was 5.2 per cent, equivalent to £73 billion. In 2010-11, following withdrawal of the temporary fiscal stimulus, the hole was expected to shrink to 4.6 per cent of GDP, or £65 billion a year; this is the size of annual repair job identified by the previous Government.

Table 1 also shows that ongoing annual deficits were expected to push PSND to a peak of 74.9 per cent of GDP in 2014-15, equivalent to £1,053 billion in 2009-10 prices.

While the global financial crisis has affected most economies around the world, pushing up government borrowing and debt across developed countries, the UK's fiscal position has deteriorated more than most. Among all advanced nations recorded in the IMF's *Global Economic Outlook*, the UK's budget deficit is expected to be the highest outside of Ireland in 2010. The UK figure – as measured by the IMF – of 11.4 per cent of GDP, compares with figures of 8.2 per cent in France, 5.7 per cent in Germany and 5.2 per cent in Italy. Similarly, the UK's structural deficit in 2010 is expected to be the highest as a proportion of GDP outside the US. The UK figure recorded by the IMF of 8.9 per cent of GDP compares with 4.6 per cent in Italy, 4.3 per cent in Germany and 3.9 per cent in France.[9]

[9] IMF, *World Economic Outlook Database: April 2010*

Table 1: Fiscal aggregates: *UK 2006-07 - 2014-15*

	Annual budget deficit	Annual structural deficit³	Annual structural current deficit	Public sector net debt
As proportion of GDP				
2006-07	2.3%	2.3%	0.4%	36.0%
2007-08	2.4%	2.6%	0.5%	36.5%
2008-09	6.1%	5.8%	3.2%	44.0%
2009-10¹	10.3%	8.4%	5.2%	53.8%
2010-11²	11.1%	7.3%	4.6%	63.6%
2011-12	8.5%	5.3%	3.4%	69.5%
2012-13	6.8%	4.1%	2.5%	73.0%
2013-14	5.2%	3.1%	1.8%	74.5%
2014-15	4.0%	2.5%	1.2%	74.9%
£ billion (2009-10 prices)				
2006-07	£32	£32	£6	£506
2007-08	£34	£37	£7	£513
2008-09	£86	£82	£45	£619
2009-10¹	£145	£118	£73	£756
2010-11²	£156	£103	£65	£894
2011-12	£120	£75	£48	£977
2012-13	£96	£58	£35	£1,026
2013-14	£73	£44	£25	£1,047
2014-15	£56	£35	£17	£1,053

Notes: ¹ GDP based on forecast.
² Figures from 2010-11 are Budget 2010 forecasts.
³ Figures from 2009-10 are Budget 2010 forecasts.
These figures do not include the temporary effects of financial interventions on the fiscal aggregates (for example, the balance sheets and operations of banks classified to the public sector) but retain the permanent effects which are recorded as they occur.

Source: HMT, *Public Finances Databank* , 27 May 2010

Budget 2010 presents a forecast for government tax receipts in 2010-11 that is £107 billion lower than the forecast included in Budget 2007. By contrast, the Budget 2010 forecast for government spending in 2010-11 is just £27 billion lower than the corresponding figure in Budget 2007.[10] This highlights that the source of deterioration in the UK is a collapse in tax receipts rather than a significant increase in spending. It reflects the dependence in the UK on receipts from the financial sector, housing transactions and corporate taxes: by basing public spending plans on assumptions of permanency of these receipts, the UK was particularly vulnerable to the bursting of the various bubbles.

While the analysis set out in Table 1 provides a sense of the magnitude of the fiscal problem that the new Government must tackle, the implied accuracy of the annual structural hole estimate is potentially misleading. In reality it is not possible to accurately estimate the size of the structural deficit at 7.3 per cent as the table suggests, because the 'output gap' – the difference between actual output and the estimated trend level of output – cannot be captured, particularly as the economic crisis has destroyed pre-2008 notions of what 'normal' looks like. Instead, the

[10] HM Treasury, *Budget 2007*, Table C4; HM Treasury, *Budget 2010*, Table C3

overall structural deficit can reasonably be considered to fall somewhere in the range of 5-10 per cent of national income.

The IFS has argued that the UK is likely to have suffered a bigger fall in potential GDP than the Treasury has estimated and that future growth of potential GDP will be reduced rather than unchanged as the Treasury assumes.[11] If the structural deficit *is* bigger than estimated by the Treasury, then the size of fiscal adjustment required is accordingly larger and overall net debt is also likely to peak at a higher level than suggested in Table 1. Again, the new Office for Budget Responsibility will produce new estimates for the 22 June Budget.

1.3.2 Implications of the problem

The persistence of the budget deficit matters primarily because of the implication for the sustainability of the UK's public finances. A country's ratio of debt to GDP is sustainable (stable or declining) in the medium term if total public spending excluding debt-interest payments is equal to total public sector receipts (i.e. there is a primary balance) and the real interest rate on government debt is equal to or less than the economy's trend rate of growth. If interest costs outpace economic growth, a country can enter an unsustainable debt cycle.

Any attempt to produce a primary balance in 2008-09 in order to maintain a constant debt-to-GDP ratio following the collapse in tax receipts discussed above would have amplified recession in the UK. Instead, the previous Government maintained planned spending and introduced a modest fiscal stimulus. This decision was made easier by the room for manoeuvre afforded by the currently low level of borrowing costs. According to calculations made by Simon Hayes at Barclays Capital, the real rate of interest faced by the UK Government is under 1 per cent. While this is expected to rise as monetary policy tightens, it is expected to remain at a level below the UK's trend rate of growth.[12] As such, while PSNB has reached its highest level since the second world war in the UK, return to primary balance over the medium-term is likely to leave the UK in a position in which servicing the country's debts remains sustainable.

The key for the UK is therefore to return to primary balance before interest costs rise above trend growth. This means setting out a credible plan for reducing the budget deficit that convinces investors that the Government will not resort to inflation – or even to default – to reduce the real cost of its debt. If investors are not convinced, or if there is a lack of demand for UK gilts (government-issued bonds), the yields (the returns paid by the Government on the gilts it issues) offered by the Government will need to increase. If gilt yields were to rise sharply, Government

[11] IFS, *Green Budget*, February 2010, pp1-5
[12] Hayes, S (Barclays Capital) in IFS, *Green Budget 2010*, February 2010, Chapter 5

debt financing costs would quickly rise, increasing the possibility of an unsustainable debt cycle.

As with the prospects for economic recovery discussed above, there is significant uncertainty over the chances of the UK entering such a cycle. There are several related potential sources of a spike in yields, but there are also a number of counterbalancing factors.

First, there is the danger that the large quantity of gilts due to enter the market in 2010 (to fund the Government's borrowing) will outstrip demand (from insurance companies, pension funds and others) and so push up yields. This danger is likely to be heightened by the ending and potential reversal of the Bank of England's intervention in the gilts market under its quantitative easing (QE) programme.

The Bank has purchased around £200 billion of gilts since March 2009, offsetting the increase in gilt issuance by the Government. Therefore, the Government has effectively borrowed on a large scale without increasing the net supply of gilts in the private sector. The – at least temporary – end to the QE programme means that net supply will begin to increase. If the Bank decided to *reverse* its activity and sell some of its gilt holdings in the coming months, then supply would increase even more significantly. In this instance, it is not clear whether the market would be able to absorb this quantity of debt, producing a risk of increasing yields.

The Treasury is confident that sufficient demand exists, and any increase in borrowing costs associated with the reversal of QE should only be temporary. Moreover, recent evidence from other European countries suggests that surges in debt issuance have relatively small effects on funding costs. However, the risk cannot simply be dismissed.

A second potential source of concern is the risk that the UK's credit rating could be downgraded from its triple-A status. Such a move would be likely to increase debt costs as some asset managers are restricted in the amounts of funds they are allowed to allocate to investments rated below triple-A. Thus the UK would lose access to some sources of funding, again increasing the likelihood that gilt supply would outweigh demand.

In May 2009, Standard and Poor's revised the outlook on the UK rating from 'stable' to 'negative' for the first time since 1975, as a reflection of its concern that public debt may approach an unsustainable level. Other ratings agencies have similarly expressed concern about the UK's position, although they have not yet altered their official outlooks.

In the UK's favour is the fact that ratings are relative and, while the UK public finances have deteriorated significantly, their starting point was stronger than in many other countries. In addition, despite some disagreement about timings and a general lack of detail, all political parties have been clear for some time that restoring fiscal balance should be the priority of the new Parliament. Improvements in the economy and the growing expectation of PSND peaking at a level well below 100 per cent of GDP have also helped to calm fears. However, while the prospect of a rating downgrade appears less likely now than it did in the first half of 2009, there is a danger that stronger economic recoveries and speedier debt reductions in other countries could leave the UK looking worse by comparison and increase warnings of action once again.

A third potential source of difficulty is the risk of 'contagion'. The euro-zone funding crisis and the prospect of Greek default has reduced investors' risk-appetites and provoked proposed and actual rating downgrades in other euro-zone countries such as Portugal and Spain. While the UK appears to be in a much stronger position – because of the ability to let the currency take the strain, relatively long average debt maturity, the country's strong reputation for producing fiscal consolidations when needed, a lower stock of debt than in Greece and elsewhere and because the UK's current account deficit is similarly lower – the risk remains that current conditions could spread outside the euro-zone and make it more difficult for the UK to maintain its current position.

Rather than existing in isolation, these three sources of danger are likely to operate in conjunction with each other. That is, if the Government struggles to find buyers for its debt in the face of a glut of gilt issuance, it would become more likely that ratings agencies would assess the risk of lending to the UK to have risen. Therefore, while the risk of entering an unsustainable debt cycle currently looks slight (assuming appropriate fiscal consolidation is entered into in the coming years), the consequences of failing to set out a clear plan for dealing with the deficit in order to reassure investors are potentially severe.

1.3.3 Defaulting

The UK is highly unlikely to explicitly default on its debt by refusing to meet its original borrowing terms. However, investors are likely to be more nervous about the prospect of implicit default via inflation. Despite some apparent benefits, however, such action is unlikely to be in the interests of the UK in the longer-term. A period of inflation would lower the real value of government debt. At the same time, it would benefit indebted households and businesses, and may therefore help to boost domestic demand. However, recourse to this measure would be likely to produce higher long-term borrowing costs that would increase debt-interest payments and so negatively impact on the Government's spending plans for some considerable time.

Analysis of the impact of inflation on deficit reduction in the early 1980s by Wilkes highlights the consequences.[13] He shows that the benefits gained from allowing inflation to reduce the real cost of government debt came at the cost of interest rates that did not fall below 7 per cent for the remainder of the Conservative period in power. Investors' determination to protect themselves from a similar recourse to inflation in the future led them to charge premiums of around 4 per cent on the money they lent to the Government in the early 1980s. Subsequent falls in inflation meant that the real costs of these premiums grew considerably. The legacy effects of these debts increased the level of primary surpluses required to maintain the debt-to-GDP ratio for the following 20 years, thereby constraining the spending power of several administrations.

In addition, as the IMF has argued, inflation carries many other risks with it, not least that once unleashed it is difficult to control. It also creates distortions in resource allocation, reduces economic growth and is likely to hurt the poor more than the rich because they are less likely to access saving and investment products that provide protection from inflation.[14]

Today's low borrowing costs reflect the improvements in the UK's reputation secured in the last two decades. It would be unwise for the Government to put this in jeopardy by invoking an implicit default, pointing once again to the conclusion that a fiscal consolidation of sorts is unavoidable and that urgent action needs to be taken to reassure the markets and maintain the new bargain that has developed in which governments guarantee stable prices in return for favourable borrowing and repayment terms.

1.3.4 Plans for closing the deficit

Pre-election: Labour Government

The Labour Government established a Fiscal Consolidation Plan in legislation – set out in the Fiscal Responsibility Act 2010 – which extended from 2009-10 to 2015-16 and required the Government to:

- halve PSNB as a share of GDP in 2013-14 compared with the level in 2009-10;
- reduce the budget deficit in each and every year from 2009-10 to 2015-16; and
- ensure that PSND is falling as a share of GDP in 2015-16.

A further target included in secondary legislation set a target for Government to reduce PSNB to 5.5 per cent of GDP or less in 2013-14.

[13] Giles Wilkes, CentreForum, *A balancing act: fair solutions to a modern debt crisis*, 2009
[14] IMF, *A Strategy for Renormalizing Fiscal and Monetary Policies in Advanced Economies*, February 2010

Budget 2010 set out Labour's proposed route map, involving the withdrawal of the temporary fiscal stimulus in 2010-11 before beginning the tightening process in 2011-12. Under the proposals, the estimated structural current deficit would have been filled by 2016-17.

According to IFS calculations, Labour's plans involved closing the deficit by introducing £2 spending cuts for every £1 tax rise in the period to 2014-15. The Budget provided no breakdown of the balance intended to complete the remaining 30 per cent of tightening planned for 2015-16 and 2016-17. However, maintaining the same balance of tax and spending for the remainder of the repair period would imply that Labour would have needed to raise an additional £24 billion a year (in 2010-11 terms) in tax revenues by 2016-17, along with £47 billion a year in discretionary spending cuts.[15]

Before the election, Labour focused primarily on tax measures – announcing increases designed to raise £17 billion of the assumed £24 billion a year. On spending cuts, the Budget had set out only a broad trajectory. Overall public sector current spending was set to increase by 0.8 per cent in real terms between 2011-12 and 2014-15, with the IFS estimating that inevitable growth in costs relating to social security and debt-interest payments would mean that funds available for public services and administration would need to be cut by 3.1 per cent in real terms every year, creating a cumulative decline by 2014-15 of 11.9 per cent.[16]

Labour's commitment to protect certain areas of spending would have affected the distribution of these cuts across departments. In 2011-12 and 2012-13, it promised to:

- increase the 95 per cent of NHS spending that supports patient care in line with inflation;
- increase spending on front-line schools by 0.7 per cent a year in real terms;
- increase spending on 16-to-19 participation by 0.9 per cent a year in real terms;
- maintain spending on Sure Start Children's Centres in line with inflation;
- keep spending on overseas aid on track to reach 0.7 per cent of Gross National Income by 2013; and

[15] IFS Election Briefing Note, *Filling the hole: how do the three main UK parties plan to repair the public finances*, April 2010, p11. The figures presented sum to £71 billion rather than the £65 billion set out in Table 1 because the IFS has based its calculations on Labour's pre-election deficit reduction plans, which went further than just closing the structural current deficit. Values are also expressed in 2010-11 terms rather than 2009-10 as used in Table 1.

[16] Ibid, p20

- provide “sufficient funding” to police authorities to enable them to maintain the number of police officers and community support officers.

IFS calculations suggest that these ring-fences would have meant that spending cuts for non-protected departmental budgets would need to amount to 5.3 per cent a year in real-terms, or a cumulative 19.5 per cent by 2014-15.[17]

Post-election: coalition Government

Since its formation, the new coalition Government has made clear that dealing with the fiscal deficit is its priority. In broad terms it has announced that it will “significantly accelerate” the reduction of the structural deficit over the course of a Parliament, with the main burden of deficit reduction borne by spending cuts rather than increased taxes. It intends to publish further details of its plan in an emergency Budget on 22 June.

As discussed above, the Government has established an independent Office for Budget Responsibility (OBR), which will produce an independent assessment of the public finances and the economy for each Budget and PBR, including June’s emergency Budget. The OBR will have full access to Treasury data, and the Chancellor will accept and take account of its forecasts in developing fiscal policy. In each Budget and PBR the OBR will confirm whether the Government’s policy is consistent with a better than 50 per cent chance of achieving the forward looking fiscal target set by the Chancellor.

The Government is proceeding with the majority of the tax changes proposed by the previous administration, and in addition it has announced its intention to:

- raise the secondary threshold at which employers start paying National Insurance by £21 a week;
- establish a “substantial increase” in the income tax personal allowance from April 2011, with a long-term aim of increasing it to £10,000;
- increase Capital Gains Tax rates for non-business assets so that they are more closely aligned with income tax rates;
- move from a per-passenger aviation duty to a per-aeroplane tax; and
- increase the proportion of tax revenue collected from environmental taxes.

In addition, the Government has set out £6.2 billion fiscal tightening in the current financial year.[18] The Government is keeping to Labour's planned increases in spending in the NHS, MoD and overseas aid over the forecast period, and has also stated that schools, Sure Start and spending on 16-19 year-olds will be protected

[17] Robert Chote, IFS Budget 2010 briefing, “Introductory remarks”, 25 March 2010
[18] HMT Press Notice, PN04/10, “Government announces £6.2bn of savings in 2010-11 Action to cut Whitehall waste and protect schools spending”, 24 May 2010

in the current financial year, although the Department for Education is still expected to make savings of £670m from elsewhere in its budget. Announced cuts include:

- £1.7 billion from delaying and stopping contracts and projects;
- £1.165 billion by reducing grants to local authorities;
- £1.15 billion in discretionary areas like consultancy and travel costs;
- £704 million from devolved administrations, although they have the option of deferring these savings until 2011-12;
- £600 million from cutting the cost of quangos
- £320 million from reducing and then stopping government contributions to the Child Trust Fund;
- £200 million by reducing other lower value spend;
- £170 million from reductions in property costs;
- £120 million from a recruitment freeze across the civil service for the rest of 2010-11; and
- £95 million through savings in IT spending.

Of the £6.2 billion total, £0.5 billion will be re-invested. The Government intends to provide: £50m for further education college capital programmes; £150m to fund 50,000 new apprenticeship places; £170m to safeguard delivery of around 4,000 otherwise unfunded social rented homes to start on site this year; and £50 million for action to tackle backdated business rates bills, including a freeze on payments for 2010-11.

While June's Budget will set out the broad path the Government intends to follow to close the remainder of the deficit, the details of spending cuts are set to be announced in the Spending Review reporting in the autumn. The review will cover spending in the period 2011-12 to 2014-15.

Rather than a simple exercise in cutting budgets, the Government has described this process as representing a "complete re-evaluation" of its role in providing public services.[19] As part of this, departments will need to show that their spending plans deliver value for money by setting out whether or not they cover activity that is essential to the Government's priorities; whether or not Government funding is required to provide the activity; and whether or not the activity could be provided more efficiently. Plans will be challenged by a Star Chamber chaired by the Chancellor and Chief Secretary.

The Government is also planning to engage with the private sector, the public, voluntary/charitable organisations and experts in order to "obtain the best ideas

[19] HM Treasury Press Notice, PN10/10, "Spending Review 2010 – the Government's approach", 8 June 2010

from those most involved in and affected by public services".[20] In addition, a Spending Review Challenge Group of internal and external experts will be established to act as independent champions of departments throughout the process. Each Secretary of State will also be asked to appoint a Minister with specific responsibility for driving value for money across their department, identifying savings opportunities and challenging spending in all areas, including on contracts and programmes.

The Government has also stated that the Spending Review will "comprehensively examine areas such as: social security, tax credits and public service pensions".[21]

1.4 Conclusions

Despite a return to growth at the end of 2009, there is significant uncertainty regarding the prospects for economic recovery in the UK. On the one hand, deep recessions often produce strong bounces and demand should continue to benefit from loose monetary policy and the depreciation of sterling. On the other hand, apparent household appetite for deleveraging and precautionary saving, growing commodity price inflation, ongoing tight credit conditions and uncertain global outlooks could all serve to constrain consumer and business spending.

Economic prospects are also dependent on the new Government's ability to tackle the public sector budget deficit. While the UK is likely to have some room for manoeuvre because of the low level of borrowing costs it faces currently and because of the country's strong reputation for undertaking fiscal consolidation when necessary, the risk of entering an unsustainable debt cycle remains. At the very least, the magnitude of the deficit is likely to cause a slight increase in borrowing costs. If the Government fails to convince investors that it has got to grips with the problem, interest rates could rise quite significantly, creating legacy effects that undermine prospects for both growth and future government spending.

Therefore, while the uncertain state of economic recovery raises questions about the timing of withdrawal of state activity (see Section 3), fiscal consolidation of sorts is unavoidable. The new Government has made clear its intention to undertake such action, and will produce detailed route maps following the Budget on 22 June and the subsequent Spending Review.

---

[20] Ibid.
[21] Ibid.

2 Low earners in recession and recovery

2.1 Defining low earners

The UK operates as a mixed economy. Markets for some goods are purely private, often attracting regulation and consumer protection mechanisms but nevertheless largely free to develop according to market forces with prices set at levels that match supply with demand. Direct redistribution takes place via the tax-benefits system which helps to reduce the gap between the poorest and richest members of society. In addition, the state is involved in the provision and funding of social goods: those goods and services that have benefits for society as a whole and form part of a citizen's basic requirements but which may be unaffordable for some if left to private enterprises. In some instances, for example healthcare and education, the state provides universal access. In other instances, for example housing and social care, the state only provides support for those it assesses to be most in need. In all cases, private markets exist alongside the public provision, allowing those with sufficient resources to choose to substitute or top-up their baseline entitlement.

The mixed economy approach combines the benefits associated with well-functioning private markets with targeted state intervention. However, it inevitably results in a group which operates at the margin. This group – *low earners* – is not the most vulnerable in society, nor is it necessarily the most deserving, but it does face often unique pressures.

In March 2010, we published the latest *Low earners audit*.[22] The report presented a statistical review of the experience of low earners in the mixed UK economy and concluded that low earners are:

- *Squeezed*: often too poor to benefit from the full range of opportunities provided by private markets but too rich to qualify for substantial state support;
- *Exposed*: living at the edge of their means and therefore vulnerable to changes in circumstances; and
- *Overlooked*: low earners are not well-defined as a group and the pressures they face are not well understood.

2.1.1 Profile

At its broadest, the Foundation defines the group as including all those with below-median income (from all sources) who are not dependent on state support. For the purposes of analysis, precise definitions depend on the data source being used. In capturing the general profile of the group we primarily use the *Family*

[22] Resolution Foundation, *Low earners audit*, March 2010

Resources Survey. In relation to this source, we use a two-stage process to define low earners:

- First, we identify those households in income deciles 3, 4 and 5: that is, with equivalised[23] gross annual income (from all sources – earnings, benefits, investments etc.) between £13,500 and £25,800;
- Secondly, we remove from the group any household receiving more than 20 per cent of its gross annual income from means-tested state benefits.[24]

On this measure, around 7.2 million households fall into the low earner group in the UK, accounting for around 14.0 million adults.[25] We define two other income groups in relation to low earners: we label households with above-median incomes (income deciles 6-10) *higher earners*, and those in income deciles 1 and 2 and those receiving more than 20 per cent of their gross incomes from means-tested benefits *benefit-dependent*. Table 2 sets out a range of summary indicators for the three income groups in 2007-08.

Significant numbers of people move in and out of the low earner group at different life-stages. Analysis of the *British Household Panel Survey* in 2006 found that around 50 per cent of identified low earners were not in the group a decade earlier. Young people in particular, many of whom are students or just starting out in their careers, will move out of the group as their income rises. In addition, the reduced earnings faced by most people at retirement means that many of those considered low earners during their working lives will fall into the benefit-dependent group in retirement, while some higher earners will drop into the low earner group. The Foundation uses a constant definition of low earner income throughout the life cycle because our concern is with the position of households relative to thresholds of private markets and qualification for public support rather than relative to peers in their age group.

[23] Equivalised for household size and composition using the McClements Equivalence Scale. This process adjusts annual household incomes, from all sources, to take account of differences in living costs experienced by – for example – a single person household and a large family household.
[24] For example, Income Support, Pension Credit, Housing Benefit, Council Tax Benefit, Income-Based Job Seekers Allowance, Child Tax Credit, Working Tax Credit etc. We do not include universal benefits such as Child Benefit and the Basic State Pension.
[25] ONS, E*ffects of taxes and benefits on household income 2007/08*, Tables 14 & 15

Table 2: Summary data for households and individuals by income group: *UK 2007-08*

000s	Benefit-dependent	Low earners	Higher earners
Households			
Total	7,000	7,200	11,200
With children	1,900	2,400	3,400
Without children	5,100	4,800	7,800
Home owners	2,600	5,100	9,500
Owned outright	2,000	3,100	3,400
Owned with mortgage	600	2,000	6,100
Social rented sector tenants	3,500	1,200	500
Private rented sector tenants	1,000	800	1,200
Individuals within households			
Total adults	11,100	14,000	23,800
Women	6,600	7,600	11,800
Men	4,500	6,400	12,000
16-29	1,700	2,100	4,100
30-54	3,600	5,300	12,900
55-64	1,900	2,100	4,100
65-79	2,800	3,400	2,200
80+	1,200	1,000	500
Total children	4,600	3,800	5,500

Source: Analysis of DWP, *Family Resources Survey 2007-08*

2.1.2 Incomes

Table 3 provides average income figures for the different income groups. Average unadjusted (i.e. non-equivalised) gross household income (from all sources) among low earners in 2007/08 was £22,000, rising to £29,100 among non-retired households. Among low earner households with working-age heads, average income from employment only was £15,800: this compares with averages of £1,600 among benefit-dependent and £43,900 among higher earner households.

2.1.3 Benefit and tax credit receipt

By definition low earners do not receive many income-related benefits, although they do receive universal benefits and they are the main beneficiaries of tax credits. Table 4 shows the numbers of each type of benefit received per 1,000 households within each of the three income groups we define. It shows that the benefits most claimed by low earner households are Winter Fuel Payments, the State Pension, Child Benefit, Child Tax Credits and Working Tax Credits.

Table 3: Average annual gross income from all sources and from employment only by income group of household: *UK 2007-08*

£	Benefit-dependent	Low earners	Higher earners	All households
Gross income from all sources				
All households	11,100	22,000	52,700	35,200
Non-retired households	13,500	29,100	59,900	41,400
Retired households	4,400	12,900	24,400	17,700
Income from employment only by age of household reference person				
All ages	1,000	8,500	38,700	20,100
All working age	1,600	15,800	43,900	27,100
16-29	1,300	15,100	39,500	21,800
30-54	1,900	17,300	47,900	31,400
55-64	1,000	8,900	33,700	18,800
65-79	100	800	6,700	2,100
80+	0	300	2,000	500

Source: Analysis of DWP, *Family Resources Survey 2007-08*

Table 4: Number of benefits received per 1,000 households by income group of household: *UK 2007-08*

	Benefit-dependent	Low earners	Higher earners
Winter Fuel Payments	774	616	361
State Pension	661	542	268
Child Benefit	316	281	291
Child Tax Credit	207	219	138
Working Tax Credit	64	125	26
DLA (mobility)	178	87	35
DLA (self care)	187	80	34
Attendence Allowance	56	50	16
Incapacity Benefit	140	47	20
Pension Credit	276	35	7
Invalid Care Allowance	46	16	5
Industrial Injury Disablement Benefit	8	12	5
Severe Disability Allowance	22	9	2
Jobseeker's Allowance	75	8	3
Income Support	292	8	3
War Disablement Pension	2	5	4
Widow's Pension/Bereavement Allowance	5	3	3
Future: DLA Self Care	6	3	1
Widowed Mothers/Widowed Parents Allowanc	2	3	2
Maternity Allowance	2	2	1
All other benefits	335	29	19
All benefits	3,651	2,179	1,247

Note: Figures do not represent proportion of households in receipt of particular benefit, because more than one award can be made to the same household.

Source: Analysis of DWP, *Family Resources Survey 2007-08*

Low earners are more likely to receive tax credits than members of either the benefit-dependent or higher earner groups. Table 5 shows that, overall, 23 per cent of low earner benefit units[26] received tax credits in 2007-08, compared with 15 per cent of benefit-dependent units and 14 per cent of higher earner ones. Among those low earner benefit units in receipt of tax credits, the average award was £76.76 per week.

Table 5: Tax credit receipt by income group of benefit unit and age of head of benefit unit: *UK 2007-08*

	Benefit-dependent	Low earners	Higher earners	All benefit units
Proportion in receipt of tax credits				
16-29	21%	17%	9%	15%
30-54	33%	59%	23%	31%
55-64	3%	8%	3%	4%
65-79	1%	0%	0%	0%
80+	0%	0%	0%	0%
All	15%	23%	14%	16%
Average tax credit award per week among all benefit units				
16-29	£14.25	£14.01	£5.33	£10.51
30-54	£28.11	£45.17	£7.30	£18.10
55-64	£1.54	£3.93	£0.77	£1.55
65-79	£0.36	£0.09	£0.08	£0.19
80+	£0.00	£0.00	£0.17	£0.04
All	£11.75	£17.63	£4.88	£9.73
Average tax credit award per week among all benefit units in receipt of tax credits				
16-29	£69.28	£84.70	£57.59	£70.35
30-54	£86.47	£76.91	£31.93	£58.40
55-64	£48.74	£49.81	£29.17	£41.70
65-79	£63.29	£37.05	£30.21	£50.80
80+	£0.00	£0.00	£70.69	£70.69
All	£79.92	£76.76	£34.42	£59.76

Source: Analysis of DWP, *Family Resources Survey 2007-08*

2.1.4 Spending

Table 6 sets out what households within each income group spend their money on each week, both as a proportion of their total spending and as a proportion of their disposable income. It shows that in 2008, low earner households spent all of their disposable income each week on average. Within this average, some low earner households will have made modest savings, but others will have been living beyond their means.

[26] 'Benefit unit' is a term that relates to a single adult or couple living as married and any dependent children. Multiple benefit units may live in a single household. For example, a single household containing a married couple, two dependent children, one adult child and a single grandparent would represent three benefit units. As with income group definitions used in Table 2 and elsewhere, benefit units are split first on the basis of income decile and secondly on the basis of means-tested benefit receipt.

Low earners spent 29 per cent of their income on average on relatively essential items such as housing, food and fuel, compared with just 15 per cent among higher earner households.

Table 6: Weekly household expenditure by income group of household: *UK 2008*[1]

	As proportion of total expenditure			As proportion of disposable household income		
Averages	Benefit-dependent	Low earners	Higher earners	Benefit-dependent	Low earners	Higher earners
Housing(net),[2] fuel & power	19%	15%	9%	22%	15%	8%
Food & non-alcoholic drinks	17%	14%	9%	20%	14%	8%
Recreation & culture	11%	13%	13%	13%	13%	11%
Transport	9%	12%	15%	11%	12%	12%
Miscellaneous goods & services	7%	7%	8%	8%	7%	6%
Restaurants & hotels	7%	7%	8%	8%	7%	7%
Household goods & services	7%	6%	6%	9%	6%	5%
Clothing & footwear	5%	4%	5%	6%	4%	4%
Communication	3%	3%	2%	4%	3%	2%
Alcoholic drinks, tobacco & narcotics	4%	3%	2%	4%	3%	2%
Health	1%	1%	1%	1%	1%	1%
Education	1%	1%	2%	1%	1%	1%
All expenditure groups	91%	86%	80%	107%	86%	67%
Other expenditure items[3]	9%	14%	20%	11%	14%	17%
Total expenditure	100%	100%	100%	118%	100%	84%

Notes: [1] Based on weighted data and including children's expenditure.
[2] Excluding mortgage interest payments, council tax and Northern Ireland rates.
[3] Including mortgage interest payments and council tax.
Average expenditure within each income group is derived by dividing gross spending recorded in *Family Spending* for the appropriate income deciles by the relevant numbers of households. Average disposable household income in each income group is derived by dividing gross disposable income recorded in *The effects of taxes and benefits on household income* for the appropriate income deciles by the relevant numbers of households.

Sources: Analysis of ONS, *Family Spending: A report on the 2008 Living Costs and Food Survey*, 14 January 2010, Table 3.2E
Analysis of ONS, *The effects of taxes and benefits on household income, 2007/08*, 29 July 2009, Table 14

2.1.5 Economic activity

In 2007-08 there were around 9.4 million working-age low earners in the UK. Table 7 shows that 78 per cent of these adults were economically active during the period on average, with 64 per cent in employment, 11 per cent in self-employment and 4 per cent unemployed. The proportions are very similar to those in the wider working-age population, where 79 per cent were active: 64 per cent in employment, 10 per cent in self-employment and 4 per cent unemployed.

However, there is a noticeable difference in the split between full-time and part-time working in the low earner group compared with the wider population. While 48 per cent of all working-age adults reported being in full-time employment in 2007-08, the proportion fell to just 40 per cent among low earners. By contrast, the proportion working part-time increased from 16 per cent among the wider population to 23 per cent among working-age low earner adults.

Working-age low earners are more likely than the population as a whole to report being economically inactive because they are looking after the family or the home. They are slightly less likely to be inactive because they have taken early retirement.

Table 7: Economic activity among working-age adults: *UK 2007-08*

	All working-age adults		Working-age low earners	
	Number (000s)	% of all working-age	Number (000s)	% of all working-age
Economically active	29,700	79%	7,300	78%
Full-time employee	18,100	48%	3,800	40%
Part-time employee	6,100	16%	2,200	23%
Full-time self-employed	2,800	7%	800	9%
Part-time self-employed	900	2%	200	2%
Unemployed	1,600	4%	400	4%
Economically inactive	7,900	21%	2,000	21%
Full-time education	1,900	5%	600	6%
Looking after family/home	2,300	6%	900	10%
Permanently sick/disabled	2,000	5%	600	6%
Temporarily sick/disabled	200	1%	0	0%
Other	800	2%	200	2%
Retired	600	2%	100	1%
All working-age	37,600	100%	9,400	100%

Source: Analysis of DWP, *Family Resources Survey 2007-08*
ONS, *Labour market datasets*

2.1.6 Qualifications

Members of low earner households tend to have lower levels of qualifications than those in higher earner households and higher levels than those in benefit-dependent ones.

Table 8 shows that almost one-quarter of low earner adults have no formal qualification, compared with 8 per cent of higher earners. A further 20 per cent of low earners have no qualification beyond GCSE/O-level. Just 17 per cent of the group have some form of university qualification, compared with 52 per cent of higher earners.

Table 8: Highest level of educational qualification of individuals by income group of household: *GB Sep/Oct 2009*

	Benefit-dependent	Low earners	Higher earners	All individuals
No formal qualification	36%	24%	8%	23%
GCSE/O-level	23%	20%	17%	20%
A-level	10%	16%	17%	14%
Bachelor	8%	14%	30%	17%
Masters/PhD	2%	3%	12%	6%
Vocation	10%	11%	9%	10%
Other	7%	10%	7%	8%
Still studying	3%	1%	0%	2%

Source: Analysis of Bank of England, *2009 NMG survey*, Sep/Oct 2009

2.1.7 Industries and occupations

Table 9 shows that 30 per cent of jobs held by working low earners in 2007/08 were in the *retail, hotels and restaurants* industrial category, representing around 2.4 million jobs. Low earners held a further 1.8 million jobs in the *education, health & public administration* sector and 1.2 million jobs in *finance & business services*.

Table 9: Workforce jobs held by low earners by industry: *UK 2007-08*

	Numbers *(000s)*	% of all jobs in industry	% of all low earner jobs
Retail, hotels & restaurants	2,400	35%	30%
Education, health & public administration	1,800	23%	22%
Finance & business services	1,200	18%	15%
Manufacturing	800	25%	10%
Other services	600	30%	7%
Construction	600	26%	7%
Transport & communications	500	28%	6%
Agriculture, forestry & fishing	200	36%	2%
Energy & water	0	12%	0%

Sources: DWP, *Family Resources Survey 2007-08*
ONS, *Labour market datasets*

Within each of the sectors in which they work, low earners are most likely to be employed in lower level jobs. Table 10 shows that 21 per cent of low earner jobs in 2007-08 were in *elementary occupations*, while just 9 per cent were categorised as *managers & senior officials* and 5 per cent were in *professional occupations*.

Low earners therefore accounted for around 1.3 million *elementary occupation* jobs in 2007-08; 0.9 million *administrative and secretarial* jobs; 0.8 million *personal service occupation* jobs; 0.7 million *sales and customer service* jobs and just 0.5 million *manager and senior official* positions.

Table 10: Occupational distribution of low earners: *UK 2007-08*

	Numbers *(000s)*	% of all jobs in occupation	% of all low earner jobs
Elementary occupations	1,300	42%	21%
Administrative & secretarial occupations	900	27%	14%
Personal service occupations	800	36%	12%
Sales & customer service	700	38%	11%
Associate professional & technical occupations	600	15%	9%
Process, plant & machine operatives	600	35%	9%
Skilled trades occupations	600	30%	9%
Managers & senior officials	500	14%	9%
Professional occupations	300	10%	5%

Sources: Analysis of DWP, *Family Resources Survey 2007-08*
ONS, *2008 Annual Survey of Hours and Earnings*

2.2 Squeezed

As discussed above, low earners are defined in relation to their position in the mixed economy. That is, even before the start of the recent recession, low earners were 'squeezed' at the intersection between private and public markets.

Our latest *Low earners audit* highlights the range of ways in which different members of the low earner group are squeezed – for example: restricted access to financial advice; complex interaction with the tax and benefit system; exclusion from both home ownership and social housing; restricted opportunities for training and progression in work; and lack of help with cost of living pressures. For the purpose of this report we provide a summary below of just those areas most relevant to the exposure low earners have faced and will face in relation to recession and subsequent fiscal consolidation.

2.2.1 Income distribution

Analysis of average incomes across the three income groups we define suggests that low earners have become squeezed relative to both the benefit-dependent and higher earner groups in recent decades.

Figure 1 sets out the various income definitions presented in data collected by the Office for National Statistics. It shows that **original income** measures returns from employment, investments, occupational pensions and other non-state sources. Changes in the share of original income going to each group therefore describe alterations in equality prior to any government intervention. A household's **final income** represents its original income plus any cash benefits and the value of any benefits-in-kind it consumes, minus any taxes paid and deductions made. Changes in government policy can therefore have a significant impact on how final incomes compare to original incomes.

Figure 1: Composition of income

	Original income	*returns from employment, investments, occupational pensions and other non-state sources*
+ cash benefits	**Gross income**	*income from all sources, before any deductions*
- direct tax	**Disposable income**	*income available for spending and saving*
- indirect tax	**Post-tax income**	*income after all taxes/deductions are paid*
+ benefits-in-kind	**Final income**	*income after all state intervention including value of public services consumed*

Chart 2 shows how shares of original and final incomes have altered across the three income groups in the period since 1977. Final income distribution has been consistently more concentrated than original income, highlighting the broadly progressive impact of government policies.

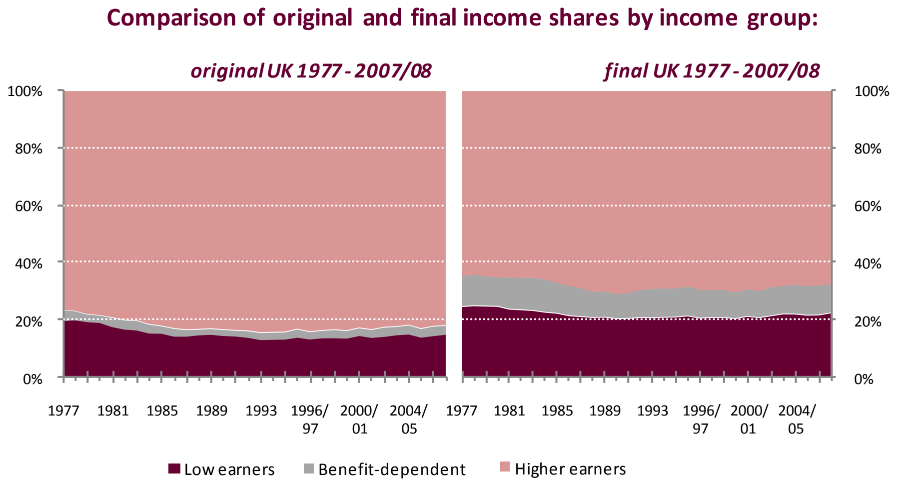


Chart 2: Share of total *original* and *final* income by income group: UK 1977-2007/08

Note: In each year, higher earners comprise 50 per cent of all households, low earners comprise 30 per cent and benefit-dependent households account for 20 per cent.

Source: Analysis of ONS, *The effects of taxes and benefits on household income, 2007/08*, Table 14

An ONS study into the redistributive effects of the UK tax and benefits system in the period 1977-2006/07 noted that cash benefits had a more significant bearing on income equality than taxes, because progressive direct taxes tended to simply cancel out regressive indirect taxes. The study found no evidence of any major change in the *magnitude* of redistribution caused by cash benefits over the period, although there was some increase in the redistribution effect of taxation from the mid-1990s onwards. The report concluded, however, that any improved equalising effect of tax and benefits over the period was limited by the large increase in inequality in original income.[27]

Chart 3 highlights low earners' shares of original and final incomes in more detail. It shows that, while the group's share of total final income has been higher in every year than its share of original income, low earner households have accounted for a smaller proportion of final income over time. In 1977, the group accounted for 24 per cent of all final income, by 2007/08 this proportion had fallen to 22 per cent: progressive policies do not appear to have been sufficient to overturn the effect of growing disparities in original incomes.

[27] ONS, "The redistribution of household income 1977 to 2006/07", *Economic and Labour Market Review*, Vol 3 No 1, January 2009

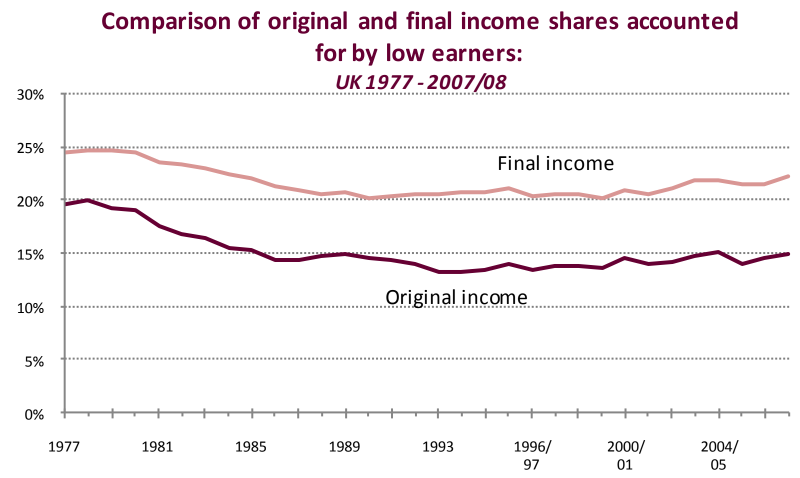


Chart 3: Low earner shares of total *original* and *final* income: UK 1977-2007/08

Note: In each year, low earners comprise 30 per cent of all households.

Source: Analysis of ONS, *The effects of taxes and benefits on household income, 2007/08*, Table 14

Chart 4 presents average low earner final income as indices of average higher earner and average benefit-dependent household incomes in the period since 1977 and shows that, within the overall trend of growing disparity in the last 30 years, low earner households became poorer relative not just to higher earner households, but also to benefit-dependent ones.

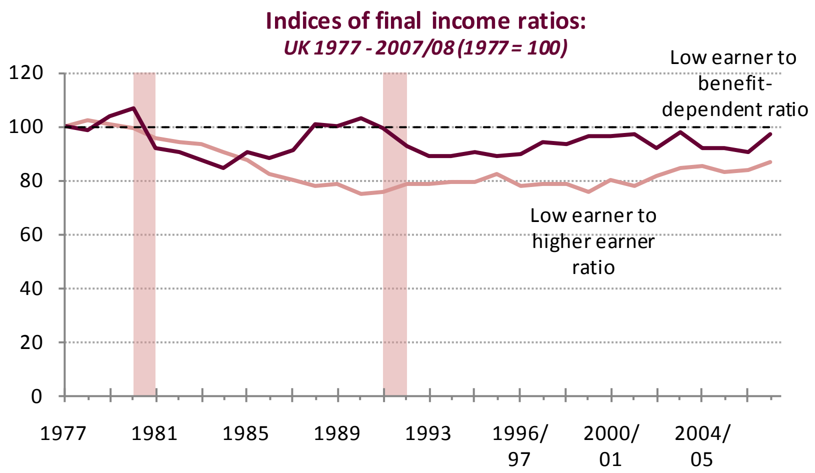


Chart 4: Low earner final income ratios: UK 1977-2007/08

Source: Analysis of ONS, *The effects of taxes and benefits on household income, 2007/08*, Table 14

The ratio of average low earner household final income to average higher earner household final income describes a relatively straightforward path. Low earner final incomes declined in relative terms between 1977 and 1989, then remained largely unchanged in the period to 2001/02, before improving slightly in more recent years. As discussed above, this improvement appears to be largely due to a slight closing in the gap in original incomes in this period. However, average low earner household final income in 2007/08 was still 13 per cent lower relative to higher earner final income than it had been in 1977.

The relationship between average low earner and benefit-dependent household final incomes has been more volatile. Low earner final incomes tended to decline relative to benefit-dependent incomes during the 1980 and 1990 recessions, reflecting growing unemployment within the low earner group. However, while the ratio returned to 1977 levels following the end of the 1980 recession, it has remained at its lower level since the end of the 1990 downturn. Again this trend appears to be a product of changes in original incomes, with original incomes within benefit-dependent households keeping pace with those in low earner ones since the early-1990s. This is likely to reflect the period of sustained economic growth and the positive effects of this on employment levels and salary growth in the benefit-dependent group. Average low earner household final income in 2007/08 was 3 per cent lower relative to benefit-dependent income than it had been in 1977.

2.3 Job retention and progression

A second area in which low earners appear disadvantaged even during economically benign periods relates to job retention and progression. Low earners are more likely than higher earners – both outside and within the same firms – to experience difficulties.

2.3.1 Barriers in work

A 2009 study by ippr noted that just 74 per cent of employees who were low-paid[28] in 2000 were in employment in 2005, compared with 83 per cent of higher earners. Workers recorded as low-paid in 2000 were twice as likely as higher earners to be unemployed and three times as likely to be economically inactive in 2005. In terms of progression, over half of low-paid workers experienced no significant improvement in income from 2002 to 2005: moves out of low pay were found to be particularly infrequent among workers who started out in skilled trades, customer service, semi-skilled manual occupations and in entry-level jobs.[29]

The report cited findings from previous studies that showed that low pay was little better than unemployment in helping people move into higher paid work, even where other factors such as age, gender and qualification were discounted. Explanations for this effect included the 'signal' low pay experience sends to

[28] Earning less than 60 per cent of median full-time earnings and more than £3 per hour.
[29] ippr, *Nice Work If You Can Get It: achieving a sustainable solution to low pay and in-work poverty*, January 2009, Tables 2.2 & 2.3

prospective employers and the detrimental effect low pay may have on workers' motivation and self-confidence.[30]

A National Consumer Council (NCC) qualitative study of a sub-set of low earners[31] in January and February 2008 identified a number of labour market concerns and barriers to progression.[32] Almost all participants in the review felt their jobs were insecure. This was a particular problem in areas with a weak local job market or an abundance of cheap labour, because respondents said they were restricted in their ability to travel or relocate for work by their lack of resources. Members of the focus groups also said that they typically worked long hours, with some doing so because they were pressured to take shifts by their employers. They also had little access to flexible working opportunities and had difficulties booking annual leave at short notice. The NCC concluded that the group was exposed because of a lack of information and understanding about employment rights, variations in those rights and differences in enforcement.

Some of the younger low earners involved in the study said that they wanted to change occupation in order to secure better working hours and improved prospects but they found their lack of experience to be a barrier. Financial realities meant that these individuals could not consider retraining in their spare time, particularly because of the irregular and limited nature of their time off.

2.3.2 Training opportunities

Lack of training is central to many low earners' inability to progress in work. Low earners in general have fewer opportunities to train in work than higher earners, because of where they work and because of their lower starting levels of skills.

Low earners are more likely than higher earners to work for small and medium-sized employers (SMEs)[33] and more likely to be self-employed (Table 7). As Chart 5 highlights, this means low earners are less likely to work in organisations that offer training. Chart 5 also shows that employers are more likely to offer training within their firm to those with the highest skills, because of the perceived better return on investment: in 2007, 53 per cent of managers and senior officials received training compared with just 7 per cent of process, plant and machinery operatives.

[30] Ibid*,* pp25-26

[31] Low-income workers (single people earning between £10,000 and £18,500; couples earning under £29,000 with neither of them earning above £18,500 individually) not living with dependent children and or claiming welfare benefits including tax credits.

[32] NCC, *More snakes than ladders? an insight into the lives of the forgotten working poor*, July 2008

[33] Alliance for Health & the Future, *Living in the Advice Gap: An Investigation into the Resolution Foundation's Target Group*

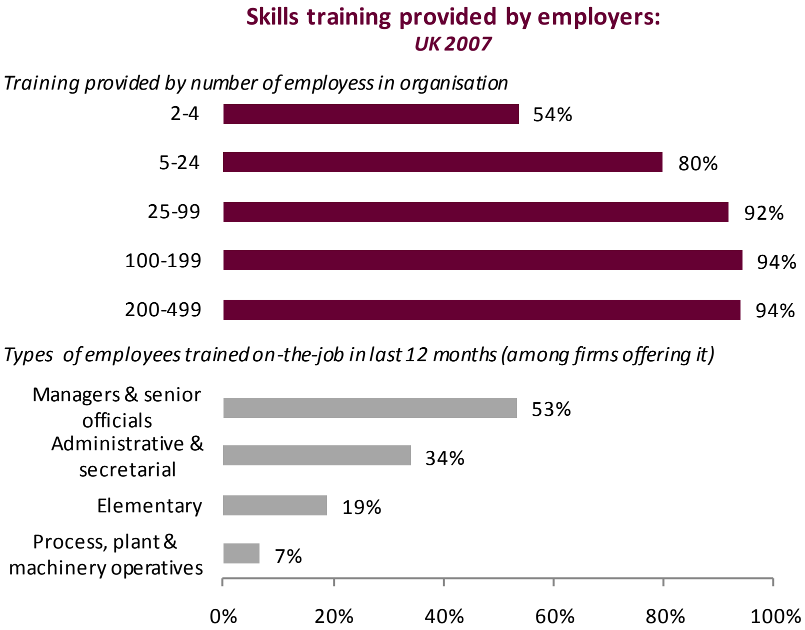


Chart 5: **Skills training provided by employers: UK 2007**
Source: Learning & Skills Council, *National Employer Skills Survey 2007*

Chart 6 shows that similarly, in Q3 2009, just 34 per cent of people in work with no qualification reported having ever been offered training or education by their current employer, compared with 68 per cent of workers with university educations. Once again low earners are therefore likely to lose out.

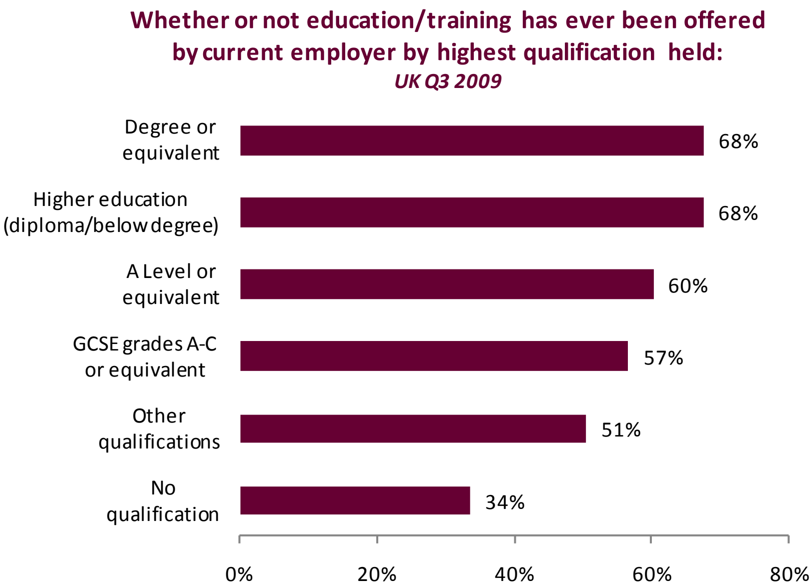


Chart 6: **In-work training by level of qualification held: UK 2009**
Source: ONS, *Labour Force Survey*

At the same time as being less likely to receive training from their employer, low earners are less likely than higher earners to be able to self-fund their own training or take time out from work to re-skill. They are also frequently unable to take advantage of government-sponsored training courses because of the focus of these on those out of work, concentration on basic skills training and qualifications and the inflexibility of available courses.

2.3.3 Jobs supply

A further barrier to progression among low earners is the declining relative supply of intermediate jobs. Chart 7 shows that, in the period since 1982, the proportion of jobs in the UK in 'higher occupations' (managers and senior officials, professional occupations) has increased significantly, while the proportion in 'lower occupations' (personal services, sales and customer services, process, plant and machine operatives, elementary occupations) has fallen only slightly. The biggest decline has therefore taken place in the 'intermediate occupations' (associate professional and technical, administrative and secretarial, skilled trades occupations), meaning that it has become more difficult for low earners to progress towards the highest skilled occupations.

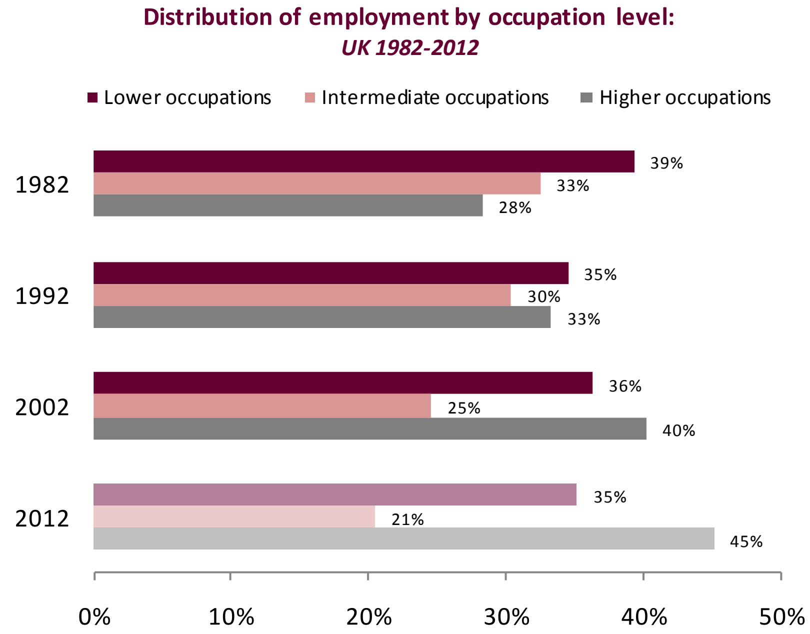


Chart 7: Distribution of employment by occupation level: UK 1982-2012
Source: ippr, *Choosing to Learn, Improving participation after compulsory education*, December 2005

This polarisation of jobs in the UK economy has been reflected in successive governments' skills policies. The emphasis of the 'demand-led' approach to training has been on employers' needs, meaning that provision in high- and basic-skill areas has outstripped provision of low- and middle-skill training. As such, qualifications have been promoted ahead of employability and the skills gap experienced by low earners described above has been accentuated.

Intermediate jobs are expected to continue to decline relative to high- and low-skill jobs, meaning that low earners' training needs are likely to remain unmet without a change of approach.

2.4 Exposed: *recession*

There have been several clearly identifiable groups that have suffered the most during the recession – the young, those outside of London and the South East, savers, men (although forthcoming job losses in the female-dominated public sector is likely to change this) and taxpayers for instance. However, within each of these groups, those most exposed are likely to have been low earners. For example, while graduate employment has clearly fallen, young non-graduates are more at risk of permanent exclusion from the workforce rather than simply deferred entry.

Our previous report – *Closer to Crisis?* – details the range of ways in which low earners have been particularly exposed by the recession. In relation to those who are already largely dependent on state benefits, low earners have been more at risk of employment-related drops in incomes and more likely to have outstanding credit commitments. In relation to those who live in households with above-median income, low earners have been less likely to be able to draw on safety nets of savings and insurance and less likely to return rapidly to employment following redundancy. As Alistair Darling highlighted in his Budget 2010 accompanying statement, it is often low earners – "those in insecure jobs or on modest incomes" – who are worst hit during economic downturns.

Chart 8 highlights that low earner households were much more likely than higher earner ones to experience a drop in left-over income in 2009, and correspondingly less likely to enjoy an increase in income, despite falls in mortgage costs. Given that low earners were already living at the edge of their means – as shown in Table 6 – they have had little option but to reduce consumption during the recession.

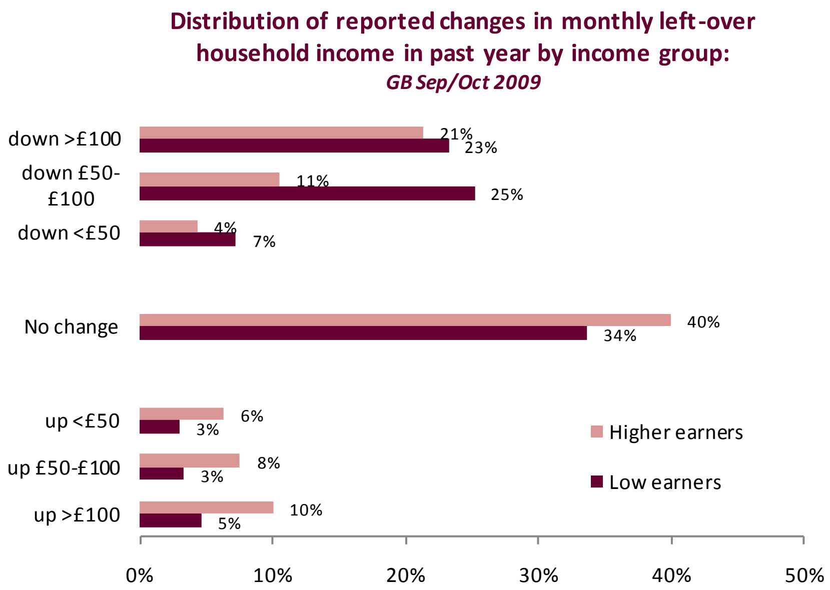


Chart 8: Change in income over course of recession by income group: GB 2009

Source: Analysis of Bank of England, *NMG Survey*

2.4.1 Exposure to labour market weakness

The various problems discussed above in relation to job retention and progression mean that low earners are likely to have been more adversely affected than higher earners by the labour market effects associated with the economic downturn.

Within all industries, low earners are likely to have been disproportionately affected by job losses because of their relative dispensability. Struggling employers are more likely to be reluctant to release highly-skilled staff who they have invested time and money in training and who will prove difficult and expensive to replace than low-skilled, low earning members of the workforce.

Table 11 offers support for this hypothesis, showing that while employment rates fell and unemployment rates rose among working-age adults with all levels of qualification in the period Q1 2008 – Q3 2009, rates remained most favourable among those with the highest levels of qualifications. The employment rate among those with no qualification fell to 37 per cent in Q3 2009, compared with 83 per cent among those with a degree or equivalent. However, given the already low level of employment among adults with no qualifications, it is not surprising that the biggest relative falls in employment rates over the period occurred among those with low- to mid-level qualifications. Similarly, Chart 9 shows that unemployment rates rose by most percentage points among those with GCSE/O-level and A-level or equivalent qualifications.

Table 11: Economic activity among working-age adults by highest qualification held: *UK Q1 2008 & Q3 2009*

	Employment rate		Unemployment rate		Inactivity rate	
	Q1 2008	Q3 2009	Q1 2008	Q3 2009	Q1 2008	Q3 2009
Degree or equivalent	85%	83%	2%	3%	13%	14%
Higher education (diploma & below degree)	78%	75%	2%	4%	20%	22%
A Level or equivalent	74%	71%	3%	5%	23%	23%
GCSE grades A-C or equivalent	70%	67%	5%	7%	25%	26%
Other qualifications	66%	62%	5%	7%	29%	31%
No qualification	38%	37%	4%	6%	58%	57%

Source: ONS, *Labour Force Survey*

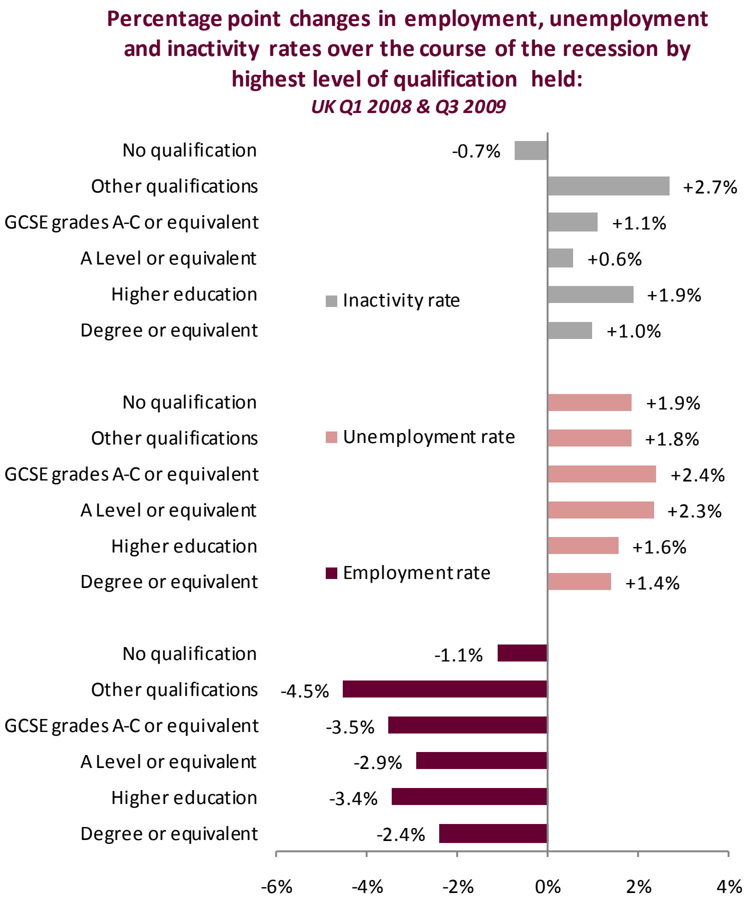


Chart 9: Changes in employment, unemployment and inactivity by qualification: UK 2008–2009

Source: ONS, *Labour Force Survey*

Table 12 produces a similar conclusion when labour market effects are measured in terms of occupation levels. While job losses since the start of the recession have been highest in proportional terms in higher-skilled occupations, absolute increases have been greatest in the occupations where most low earners work. Between April 2008 and January 2010, the number of JSA claimants reporting their usual occupation as elementary increased by 194,000; by contrast, the number of claimants from professional occupations increased by just 35,000.

Table 12: JSA claimant count by 'usual occupation' of claimant: *UK Feb 2010*

	Change in number of JSA claimants by reported 'usual occupation'			Claimants unemployed for more than six months in
(000s)	*Since Apr 2008*	*y-on-y*	*m-on-m*	Feb 2010
Elementary occupations	+197	+50	+4	195
Administrative & secretarial occupations	+75	+10	-0	53
Personal service occupations	+46	+23	+1	27
Sales & customer service	+142	+63	+9	85
Associate professional & technical occupations	+57	+15	-1	34
Process, plant & machine operatives	+91	+0	-3	73
Skilled trades occupations	+131	+19	-4	77
Managers & senior officials	+45	+4	-1	24
Professional occupations	+32	+10	-2	17

Sources: NOMIS database
ONS, *2008 Annual Survey of Hours and Earnings*

The data also suggest that lower-skilled workers are less likely than higher-skilled ones to return to work quickly: overall, 193,000 JSA claimants from elementary occupations had been on the count for more than six months in January 2010, compared with just 17,000 from professional occupations. Chart 10 shows that, among those JSA claimants leaving the count in January 2010, the average time spent on the benefit among managers and senior officials was shorter than the average among those from elementary occupations.

In addition, Chart 11 suggests that lower-skilled workers leaving the claimant count appear to be less likely than higher-skilled workers to be returning to work. Among managers and senior officials exiting the count in January 2010, 47 per cent were returning to work (or increasing their working hours to more than 16 per week). By contrast, just 24 per cent of those from sales and customer service occupations and 22 per cent of those from elementary occupations were leaving the count for this reason. While lower-skilled workers were more likely to be heading to training courses, taking all positive outcomes (work and training) together, managers and senior officials still did significantly better.

Workers from elementary and sales and customer service occupations were much more likely than managers and senior officials to leave the count for unknown reasons or simple failure to sign. DWP research suggests that people who leave the count in this way frequently return in the medium-term.

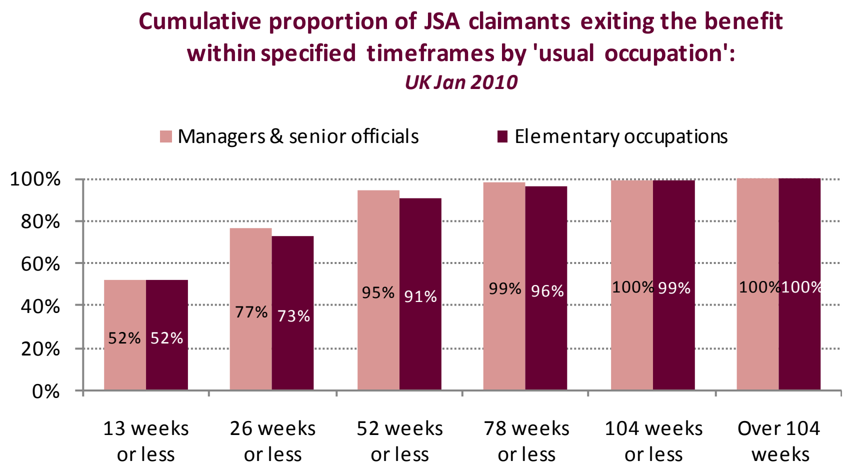


Chart 10: **Proportion of JSA claimants exiting the benefit within specified timeframes by occupation of claimant: UK Jan 2010**

Source: NOMIS database

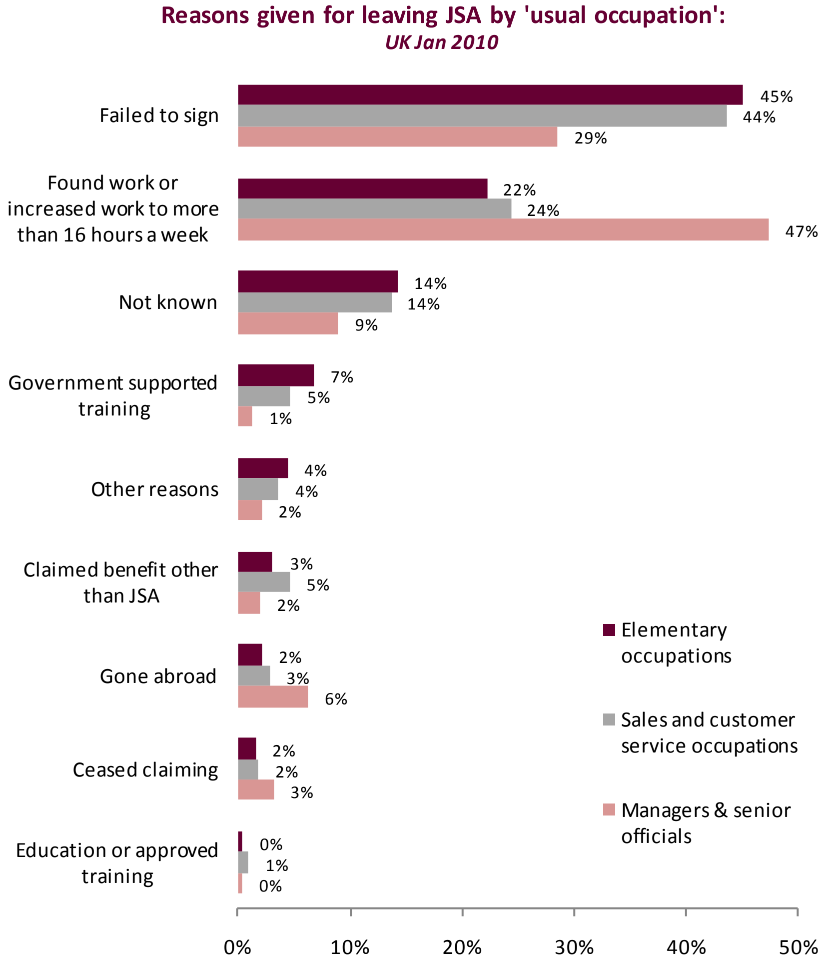


Chart 11: **Reasons for leaving JSA claimant count by occupation: UK Jan 2010**

Source: NOMIS database

2.4.2 Exposure to the consequences of job loss

In addition to being more likely to become unemployed and less likely to return to work quickly, low earners are also likely to have been more vulnerable to the consequences of these labour market issues than higher earners. In part this is because of lower levels of redundancy payments among members of the group.

Table 13 shows that, among those low earners made redundant in 2007-08, just over half received awards worth £5,000 or less, compared with just over one-third of higher earners. Similarly, just 1 per cent of low earners losing their jobs received payments over £50,000, compared with 9 per cent of higher earners. Having less access to buffer funds is likely to compound the difficulties low earners have with retraining and re-entering sustainable employment.

Table 13: Distribution of redundancy payments to individuals in past year by income group of household: *UK 2007-08*

	Benefit-dependent	Low earners	Higher earners	All households
Distribution by award				
<£1,000	21%	14%	9%	13%
£1,000 < £5,000	30%	39%	27%	31%
£5,000 < £10,000	16%	18%	18%	18%
£10,000 < £50,000	27%	27%	36%	32%
£50,000 < £100,000	5%	1%	7%	5%
£100,000 +	0%	0%	2%	1%
Average award	£10,680	£9,330	£17,670	£13,930

Source: Analysis of DWP, *Family Resources Survey 2007-08*

Low earners' vulnerability also stems from the lower levels of protection (savings and insurance) enjoyed by the group. Table 14 shows, for instance, that around half of benefit units in the group have savings equivalent to less than one month's income, with this proportion rising significantly among family units headed by younger members of the group.

Table 14: Low earners' savings adequacy by age of head of benefit unit: *UK 2007-08*

	16-29	30-54	55-64	65+	All ages
Savings equivalent to					
less than one month's gross income	76%	70%	32%	22%	50%
more than one but less than two month's gross income	8%	8%	8%	7%	8%
more than two but less than six month's gross income	10%	9%	13%	16%	12%
more than six months' gross income	6%	13%	46%	55%	30%

Source: Analysis of DWP, *Family Resources Survey 2007-08*

2.5 Exposed: *recovery*

Having been squeezed during economically benign times and exposed during the recent downturn, there is a danger that low earners will once again bear the brunt of pain during a period of fiscal adjustment as the new Government attempts to close the budget deficit.

Public spending cuts will tend to affect less affluent members of society more than the rich, due to the former's greater reliance on state support and subsidy. The impact could fall particularly heavily on those at the margins of state assistance and those who currently are most disadvantaged by the mixed economy. The distribution of pain throughout society and the extent to which the Government is prepared to intervene to manage the situation will represent key choices during the fiscal adjustment phase.

2.5.1 Tax-benefit balance

Chart 12 shows the average balance between tax and benefits achieved by low earner households in the period from 1977: a positive balance indicates that the value of benefits (in terms of both cash and use of public services) consumed by households is greater than the value of taxes paid, on average. It shows that, overall, low earner households have been net beneficiaries of the tax-benefits system, and that the positive balance increased from 2000-01.

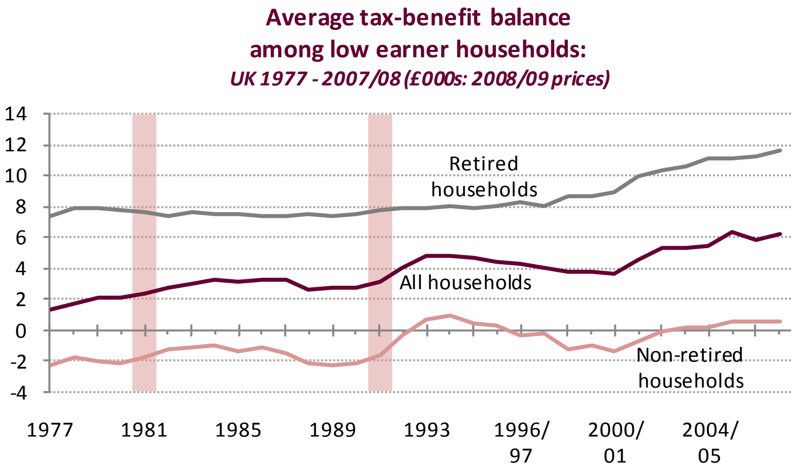


Chart 12: Tax-benefit balance among low earner households: UK 1977-2007/08
Source: Analysis of ONS, *The effects of taxes and benefits on household income, 2007/08*, Table 14, 16 & 18

While retired low earner households tended to benefit most, non-retired low earner households fluctuated around a neutral tax-benefit position over the 30 year period. The position has been positive in each year from 2003/04, however, driven largely by increases in the value of benefits-in-kind consumed by the group, which reflects real terms increases in government spending on services such as health and education.

Given the replacement of private spending with public in the past two years and the rise in unemployment (and therefore benefit payments) among low earners, it is likely that the group's positive tax-benefit balance has improved further in 2008-09 and 2009-10. However, fiscal consolidation will reduce significantly the value of benefits-in-kind available to low earners and so is likely to push their balance back into negative.

The ONS figures underpinning this analysis capture those tax revenues and areas of government spending which can be "reasonably attributed" to households. It is therefore incomplete, because it is difficult in some instances to assign contributions (such as corporate tax payments) and net benefits (such as spending on defence) by household income.

In total, the ONS study covers 60 per cent of total revenue and 50 per cent of total spending. This has implications for the completeness of the findings above and, more importantly, for the ability of the Government to assess the distributional impact of various routes to fiscal consolidation. To assist in this exercise, a recent study by the economic consultancy Volterra for the Commission on 2020 Public Services attempts to allocate those parts of spending and revenues that are missing from the ONS study, either by introducing new assumptions about their distribution (for example, corporate and business taxes are assumed to increase consumer prices and are therefore allocated on the basis of the distribution of the indirect tax burden) or by employing a simple 'per head' approach.[34]

By definition, the study makes leaps that the ONS does not consider "reasonable", and should therefore be treated with caution. Nevertheless, the approach produces some interesting indicative findings.

The main conclusion is that inclusion of all spending and revenues increases the level within the income scale at which the tax-benefit balance is neutral. That is, while under the ONS study, the point at which non-retired households switch from being net beneficiaries to net contributors in 2006/07 appears to be somewhere between deciles 5 and 6, in the Volterra study the tipping point is somewhere between deciles 6 and 7, meaning that only the top 30-40 per cent of earners pay more in tax than they receive in benefits. This is likely to reflect, in part, the fact that the ONS study is missing 50 per cent of all spending and just 40 per cent of revenues; inclusion of the absent data should therefore boost net benefits for members of all income deciles. A second factor is the fact that the additional tax allocation weighs more heavily on the higher half of the income distribution.

This finding means that the tax-benefit neutrality displayed among working-age low earner households in Chart 12 is likely to understate the level of benefit enjoyed by the group. This is an important finding. Generally, low earners have a

[34] 2020 Public Services Trust, *The Fiscal Landscape: Understanding contributions and benefits*, November 2009

strong sense of "fairness".[35] They feel that they should receive services from the state according to their contributions to tax revenues. Given the likelihood of a reduction in their net benefits during a period of consolidation, evidence suggesting that their position remains broadly positive will be important to secure their support.

2.5.2 Tax-benefit composition

The Volterra report also provides useful analysis of the types of benefits received and taxes paid by different groups within each half of the income distribution. Consideration of these findings should form an important element of planning for consolidation. For example, Chart 13 highlights the relative importance of cash benefits to members of the lower half of the income distribution and the relative importance of services such as law and order and defence for members of the top half. Chart 14 presents a similar analysis for taxes paid.

Both charts highlight the differences within income groups between different household compositions. Most obviously, education services are estimated to be worth an average £6,800 a year to working-age households with children in the lower half of the income distribution, but just £1,400 to those in the same income bracket that don't have children. Similarly, while employee National Insurance contributions amount to an average £2,300 a year in working-age households with children in the lower half of the income distribution, retired households in this income band make no such contribution.

These differences point to a further complication in any attempt to protect low earners from being disproportionately affected by consolidation – namely that *within* the group, individuals and households will have sensitivities to different areas of tax and spending.

Overall, the Volterra and ONS analyses of tax-benefit balances and compositions reinforce the need for a considered approach to fiscal tightening. A simple salami-slicing of spending would fall heaviest on those who are the main beneficiaries of the current framework of benefits and public services, with potentially perverse outcomes.

[35] Resolution Foundation, *Lost: Low earners and the elderly care market*, February 2008, p9

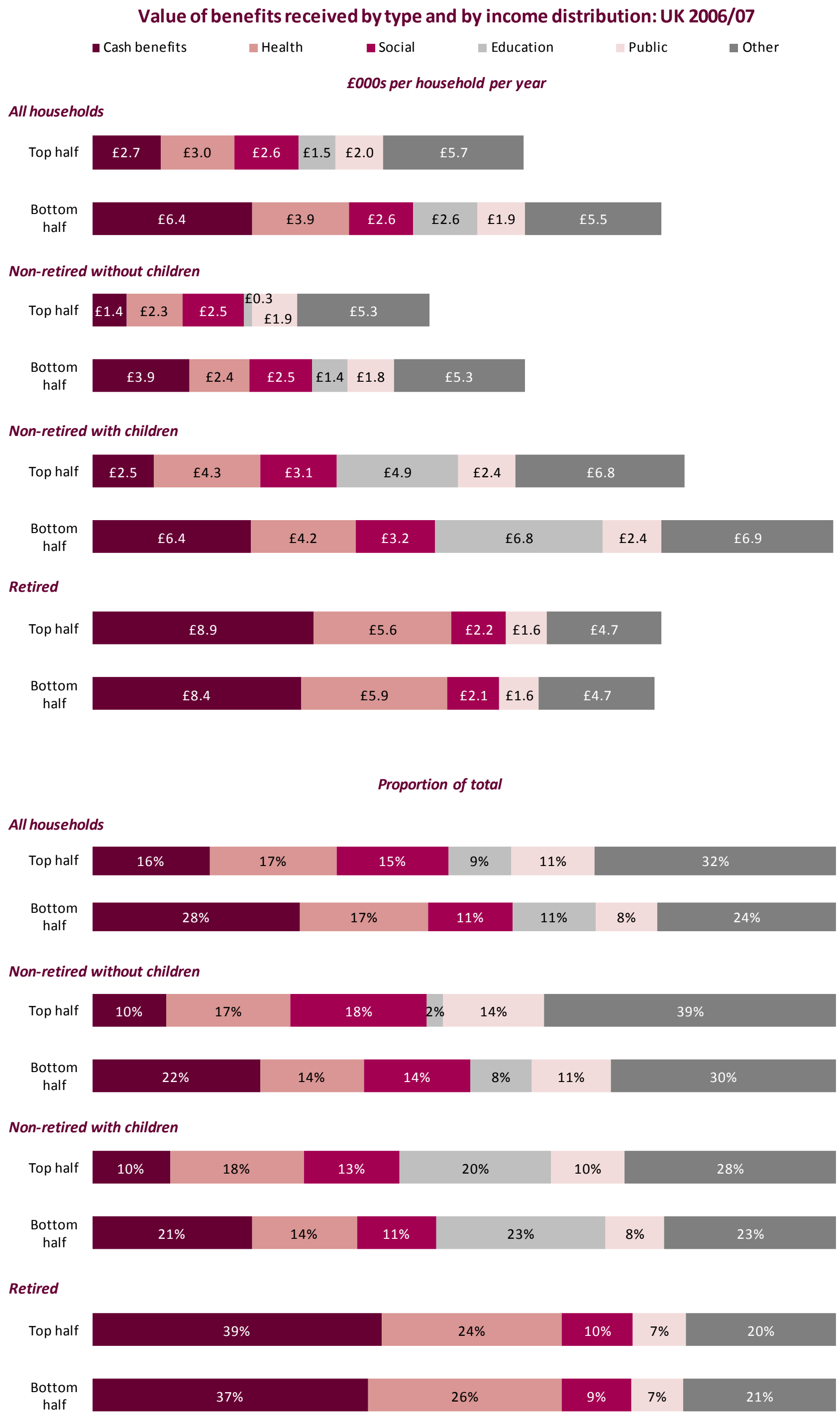


Chart 13: Distribution of government spending by benefit type: UK 2006/07

Note: ‘Social’ covers social protection spending not allocated in the ONS study (under cash benefits), including: Old age, sickness and disability; Family and children; and Housing. ‘Public’ is all spending allocated by HMRC as ‘general public services’, including: public debt transactions and executive and legislative organs; financial and fiscal affairs; external affairs; and foreign aid. ‘Other’ covers public services such as: defence; public order and safety; economic affairs; environment protection; housing and community activities; recreation; culture; and religion.

Source: Analysis by Volterra, published in 2020 Public Services Trust, *The Fiscal Landscape: Understanding contributions and benefits*, November 2009, Figures 4 & 6

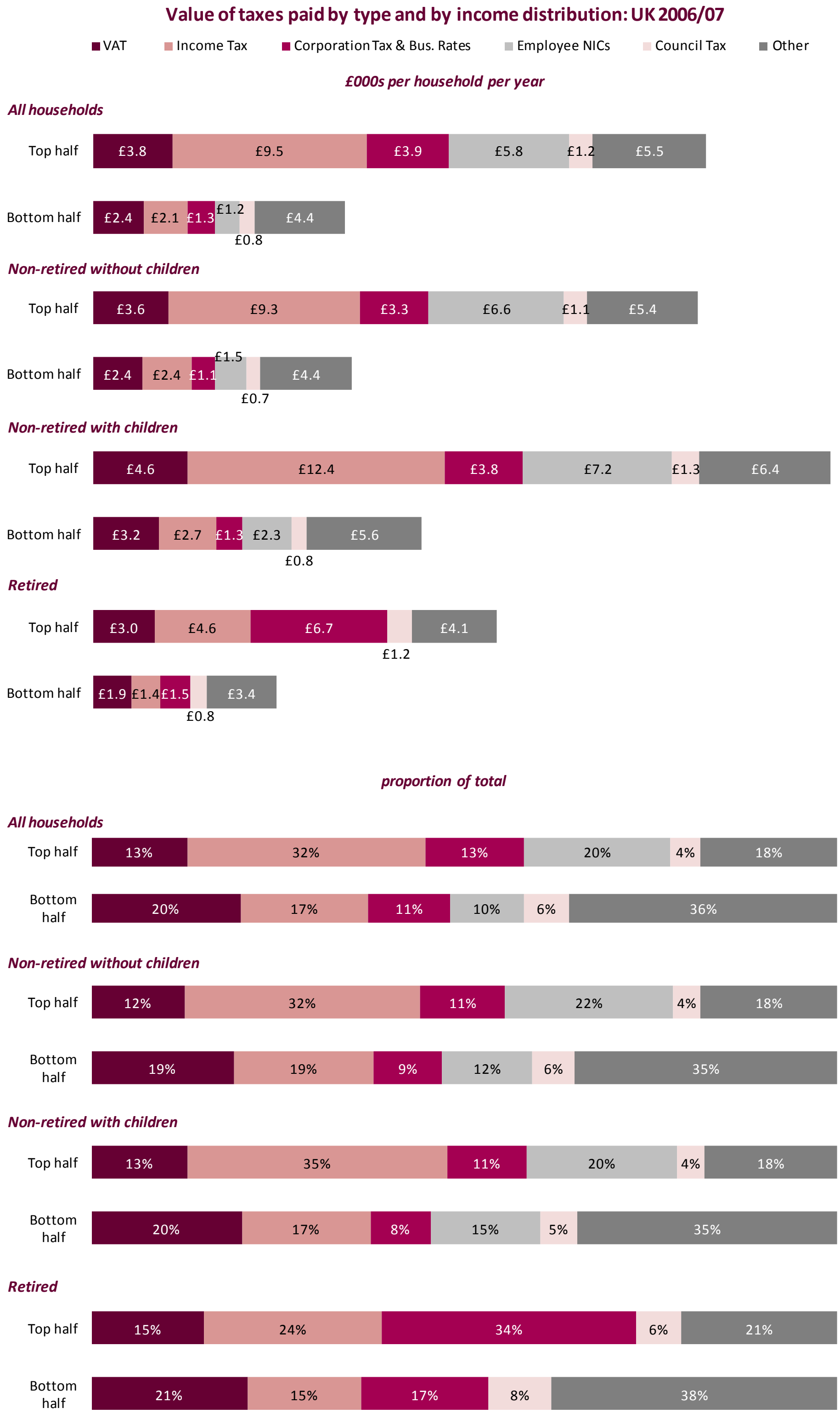


Chart 14: Distribution of tax contributions by tax type: UK 2006/07

Note: 'Other' includes fuel and vehicle excise duty, alcohol and tobacco duties and other indirect taxes.

Source: Analysis by Volterra, published in 2020 Public Services Trust, *The Fiscal Landscape: Understanding contributions and benefits*, November 2009, Figures 5 & 7

2.6 Conclusions

Low earners operate at the margins of the mixed economy and are therefore by definition squeezed: too poor to access all of the opportunities provided by private markets, and too rich to qualify for significant state support. They have not shared equally in the spoils of economic growth in recent decades; growing poorer not just in relation to richer households, but also in relation to those households below them in the income distribution. Even during economically benign times they have been disadvantaged in relation to work and housing opportunities, and they have displayed poor financial health.

The recession highlighted the exposure of the group. In relation to benefit-dependent households, low earners had jobs to lose, mortgages and credit arrangements to default on and a lack of experience in accessing support from the state. In relation to higher earners, the group had smaller safety nets – in terms of savings, insurance and redundancy payments – and displayed less ability to return rapidly to work following job loss. While the economy is now in recovery, low earners are likely to continue to struggle because of ongoing weaknesses in the labour and credit markets.

Moreover, the difficulties low earners face in accessing private market solutions, combined with their position on the cusp of state support means that the group risks being disproportionately affected once again in relation to fiscal consolidation. Therefore, in developing its plans for reducing the deficit, the new Government must make sure that the needs of low earners are not overlooked. While low earners should not be entirely insulated from the process, their circumstances and needs require special consideration to ensure that they do not bear the brunt of adjustment pain.

3 Fiscal consolidation process

Section 1.3 set out the size of the fiscal deficit problem in the UK and the implications of failing to take action. There is broad consensus, both across political parties and wider commentators, of the need for some form of fiscal consolidation and the new Government has stated that this is its priority in the current Parliament. Section 4 considers the impact of some specific proposals on low earners. However, the *process* of consolidation is also of importance to the group. Questions in relation to this process include:

- the criteria by which consolidation should be judged;
- the design principles of tightening;
- the trajectory of adjustment; and
- the balance between spending cuts and tax rises.

This section therefore summarises some of the debates in each of these areas and presents Foundation thoughts on appropriate approaches.

3.1 Criteria for assessing consolidation options

In assessing the range of possible mechanisms for cutting the budget deficit, the new Government should adopt three main criteria.

First, consideration should be given to **fairness**. As the analysis in Section 2 showed, inequalities have tended to grow in recent decades, despite broadly progressive government policies. Any attempt to close the deficit that does not have regard for fairness risks reinforcing existing inequalities by reducing the role that the state plays in equalising incomes and correcting market failures.

Secondly, options should be assessed against their likely impact on economic **growth**. Stronger growth both makes the deficit easier to cut, by automatically raising revenues and cutting costs, and provides more opportunities for low earners and others to weather a period of tightening: if public sector withdrawal is to be successful, private sector recovery needs to take the strain. This will require the Government to have regard for the effect of consolidation options on incentives to work, save and invest, as well as on wider imbalances within the economy.

Thirdly, all options should be considered in relation to their **sustainability**. While a number of approaches can be taken that have regard to the two criteria above, the ultimate purpose of the exercise is to return the public finances to balance. To this end, emphasis will need to be placed on those areas of spending and tax receipts that offer the most potential for closing the deficit on a permanent basis. Action will also need to be thought through and joined-up. That is, options that simply shift costs from one area of Government to another, or from one time period to the next, will not improve the situation.

3.2 Design principles

In the past two years, several efforts have been made to highlight the lessons that can be learned from successful consolidations in the UK and elsewhere, producing a broad consensus about how deficit reduction should be approached.

For example, a 2009 study by the Institute for Government, based on a series of expert seminars and interviews, identified a number of useful principles. Its most fundamental finding was the importance of conducting a comprehensive strategic review, which is likely to take several months to complete, prior to taking any action.[36]

In more detail, the study pointed to the development of a mandate via the establishment of zero-based debates across society about the purpose of the state and the extent of government reach. Crucially, these debates are not simply opportunities for the public to sound-off, but instead help to inform decisions. To maintain this mandate, the report concluded that any eventual consolidation plan should be presented as a single package, making clear the trade-offs between different members of society.

In addition to focusing attention on the fairness criterion, this approach can also help to avoid a rush to produce highly visible and cashable, but potentially inappropriate, savings or revenues in the early stages of tightening. Instead, a measured and fully thought through approach that produces honest evaluations of the scale of the challenge is likely to carry more credibility, be more sustainable and do less damage to long-term growth.

The Institute for Government study also highlighted the importance of political will from the centre – in the form of strong leadership from the Prime Minister and Chancellor. As the process moves away from the centre though, the report identified the usefulness of allowing departments and those responsible for delivering new spending plans the freedom to design appropriate cuts. In this process, the Treasury, Number 10 and the Cabinet Office should limit themselves to challenging proposed plans to make sure they are realistic, and providing strategic direction to prevent cross-cutting issues falling through the cracks.

The Spending Review process set out by the new Government – detailed in Section 1.3.4 – appears to recognise these findings.

[36] Institute for Government, *Undertaking a fiscal consolidation: A guide to action*, 2009

3.3 Trajectory

Debates in this area have tended to centre on the trade-off between balancing the budget deficit without harming economic recovery:

- On one hand, tightening too soon and too hard could put growth at risk by withdrawing government spending before momentum in the private sector is strong enough to take the strain. In this instance, the economy could falter and possibly return to recession, making it all the more difficult to close the deficit
- On the other hand, tightening too late or too slow risks increasing concerns among international investors about the UK's ability to deal with the deficit, potentially pushing up borrowing costs and thereby reducing the economy's growth prospects. Ultimately, this could thrust the UK into an unsustainable debt cycle

The debate on when to begin the consolidation process, which was most apparent in 2009, has to some extent been overtaken by realities: as discussed in Section 1.3.4, the new coalition Government has announced cuts of £6.2 billion in the current financial year.

Those who had argued against any action in 2010 are unlikely to be too troubled by this announcement however. The magnitude of cuts is small relative to the size of the deficit, particularly as the £0.7 billion that the devolved administrations are responsible for can be deferred to next year and a further £0.5 billion is set to be reinvested. In-year net savings of £5 billion would represent less than one-tenth of the total annual adjustment required. Therefore this year's action, while representing a start to the consolidation, is a modest one and there remains division between economists about the pace at which tightening should now proceed.

Those arguing for greater speed suggest that investor sentiment is unlikely to improve if the Government fails to take urgent action. As discussed in Section 1.3.2, credit rating agencies have previously questioned the appropriateness of the pace set out in Labour Government budget and pre-budget plans. Recent unease in the markets due to the growing euro-zone funding crisis has added weight to the argument for faster action. Even some who would not favour rapid action while the economic recovery remains nascent have suggested that it is preferable to implement cuts while we still have some autonomy, rather than having more stringent measures imposed in the future by faceless financiers.

Advocates of rapid consolidation argue that consumers and businesses have already factored-in future tax rises and spending cuts (Ricardian equivalence), meaning that fiscal tightening would not have the devastating effect on economic growth that some suggest because the private sector has already modified its behaviour by saving more. They also argue that withdrawal of government spending would reduce 'crowding-out' effects, whereby private sector access to funds for investment is constrained by the high level of public sector borrowing, thus providing a boost to growth. As evidence of the expansionary effect consolidation can have, they point to a number of previous cases in the UK and elsewhere which suggest that tightening is accompanied by growth.

Those in favour of front-loading the tightening path suggest that it is better to make a strong start and then ease off later if growth is good. This argument is given greater weight by the fact that a range of demographic factors expected in the long-term – for example, the ageing population and the increase in chronic health issues such as obesity – are likely put significant upward pressure on some parts of government spending in the coming decades.

A final argument for front-loading centres on political considerations. The new Government is likely to be given some leeway by the public to introduce a period of painful adjustment, but this mandate is likely to ebb in the face of continued public service disruption, a factor that will surely grow in importance as the next election approaches. Similarly, a shorter more intense period of tightening could avoid the risk of adjustment fatigue, with its associated negative impacts on public sector morale.

By contrast, those arguing for a more gradual approach to consolidation claim that there is no evidence as yet of any Ricardian equivalence or crowding-out, meaning that there is no urgency to tighten fiscal policy for these reasons. They point to the continued low borrowing costs faced by the Government as evidence of relative calm in the markets, and suggest that the euro-zone crisis only makes the UK look better by comparison. Instead, they are more concerned about the ability of the private sector to take the strain of economic recovery, arguing that too-big a withdrawal of government activity in the early stages of consolidation could thrust the economy back onto a downward path.

This group points out that the evidence of expansionary consolidation episodes cited by their opponents is drawn from countries and time periods when interest rates were initially high, leaving scope for monetary loosening to offset fiscal tightening. Such room for manoeuvre is not present today in the UK: the Bank of England base rate is at a historic low of 0.5 per cent, there is £200 billion of quantitative easing already in place and the exchange rate has fallen considerably since the start of the credit crunch. In these circumstances, the offsetting boost that monetary policy can offer will be limited to maintenance of a loose stance for longer than would be considered appropriate in the absence of fiscal consolidation.

The gradualist argument appears to be given support by an OECD study of past fiscal tightening case studies, which notes that episodes of lower intensity – as measured by the total size of consolidation per year – tend to be sustained for longer, and that longer programmes produce larger total tightening.[37] High intensity episodes were believed to have shorter time spans either because adjustment fatigue set in more quickly or because of the tendency of governments to target large low-hanging-fruit in an initial burst, before subsequently finding it harder to find additional savings.

The argument is finely balanced, clouded by the two great unknowns discussed in Section 1: the strength of economic recovery and the size of the structural deficit. If the economy grows more strongly than anticipated and the size of the structural hole is bigger than estimated, then those advocating tougher action on the deficit would appear to be vindicated. If, however, the economy is shakier than hoped and the deficit more cyclical than suggested, then a steadier approach is likely to be better.

One means of factoring in these uncertainties is to make the pace of tightening contingent on the performance of the economy, as suggested by Mervyn King for example.[38] There is a risk that investors might be sceptical of apparently arbitrary action by the Chancellor to slow down the pace of consolidation in response to changes in economic undercurrents, but credibility requires realism. Therefore, an acknowledgement of the need for flexibility in the face of different economic conditions, market sentiment and external unknowns (such as a crisis in the euro-zone), should be advanced as a positive approach.

Martin Wolf has suggested, for instance, that tightening plans could be announced that respond automatically to recovery.[39] A recent paper from the Progressive Economics Panel offers one such approach. It suggests that tests should be based on a range of variables and indicators in order to provide a detailed assessment of performance. It argues that backward-looking variables covering the current account, consumer spending, household savings, housing investment and business investment could be complemented by forward-looking indicators of consumer and business confidence. Further, the paper proposes that assessment should be carried out by an independent panel which could advise politicians whether the economy was in a position to withstand tightening and of

[37] OECD, *Economic Outlook No. 81*, June 2007, Chapter IV
[38] Response in Treasury Select Committee Minutes of Evidence, *Bank of England November 2009 Inflation Report*, 24 November 2009, HC (2009-10) 34, Q35
[39] Martin Wolf, *Financial Times*, "Give us fiscal austerity, but not quite yet", 24 November 2009

what magnitude, although the final decision would rest with the Government.[40] The new OBR could provide precisely the expertise to take on this role.

3.4 Balance

In attempting to meet the first of the criteria set out above – fairness – a package could be designed that is based entirely on taxing the rich. However, this is likely to fail in terms of both criterion two (growth), because of the distortions it would create, and criterion three (sustainability), because of the limited revenues that can be raised from a narrow tax base and because of political difficulties.

As an alternative, all of the tightening could be achieved via cutting spending. However, this would fail criterion one, because it would fall heaviest on those who are currently the biggest users of public services, who tend to be in the bottom half of the income distribution. Given the magnitude of the deficit reduction required, excessive spending cuts might also cause difficulties in relation to criteria two and three. Instead, the appropriate balance is likely to sit somewhere between these two extremes.

3.4.1 Optimal balance

In relation to criterion two, evidence from a range of consolidations taking place in the UK and elsewhere suggests that those which rely more on spending cuts than on tax rises are associated with stronger growth and lower increases in the natural rate of unemployment. For example, the OECD study of past consolidations cited above also concluded that programmes that emphasised cuts in current expenditure – especially spending on social transfers – tended to be longer lasting and ultimately more successful at stabilising the debt-to-GDP ratio than those that were based primarily on tax rises or cuts in investment.[41]

The paper suggested that one possible reason for the apparent relationship between spending cuts and growth is that a focus on expenditure puts downward pressure on interest rates and therefore creates a favourable environment for private sector activity. However, the already historically low level of interest rates in the UK means that this reasoning may lack some relevance in the current context. There does, though, remain scope for some relative monetary loosening by holding interest rates lower for longer than would normally occur during a period of economic recovery.

Some commentators have taken this conclusion further still and argued that the UK economy would benefit from the introduction of tax cuts as a means of promoting growth. For example, Forsyth and Taylor suggest that the costs associated with improving the UK's tax competitiveness would represent an

[40] Progressive Economics Panel, *Testing time: Addressing the Deficit without Risking the Recovery*, March 2010
[41] OECD, *Economic Outlook No. 81*, June 2007, Chapter IV

investment in repairing the budget deficit.[42] They argue that the economy needs to shift away from domestic consumption and towards exports and investments and that, in order to do this, SMEs need to be nurtured via targeted tax cuts.

The evidence in favour of focusing on cutting current expenditure rather than cutting investment or increasing taxes appears compelling, and increasing the competitiveness of the UK at the start of a period of global economic recovery certainly has merit. However, as a recent review of evidence published by the IMF acknowledges, tax revenues still have a role to play. In particular, tax increases appear to be useful in the early stages of a consolidation, as a means of reducing the need for sensitive spending cuts prior to the establishment of public support.[43] A second OECD paper notes that the magnitude of adjustment needed in the present circumstances mean that reliance on spending cuts alone would be likely to have some negative supply-side consequences and that tax increases should therefore be considered.[44]

Moreover, despite the evidence suggesting that it is better to weight the balance of adjustments towards spending cuts, the majority of episodes considered in the first OECD paper were based on larger contributions from revenue increases than from expenditure cuts. Likewise, within the UK, the consolidations that took place in the 1980s and 1990s were both evenly balanced between tax and spending measures. It is not clear why governments have consistently turned to tax increases, despite their apparent negative effect on growth, but it may reflect the political difficulty of introducing swingeing spending cuts.

Given that the departmental spending cuts implied by the new Government's deficit reduction plans are set to be among the biggest implemented in the UK since the second world war, political realities mean that there is a possibility that tax rises may again take an equal share of the burden for consolidation in this episode.

3.4.2 Principles for raising tax revenues

Tax revenues can be raised by increasing existing rates or by introducing new taxes. While both approaches are potentially valid, changes made in isolation, with the sole goal of raising revenue to reduce the deficit, run the risk of increasing complexity in the system and proving unsustainable in the long-run. The need to improve the tax-take also offers the opportunity for more fundamental reform. For example, a recent paper by the Green New Deal Group suggests that more than £100 billion is lost each year in loopholes and non-

---

[42] Michael Forsyth and Corin Taylor, Centre for Policy Studies, *Go for growth: Cut taxes now to cut debt*

[43] IMF, *Strategies for Fiscal Consolidation in the Post-Crisis World*, 4 February 2010, Box 2

[44] OECD, *Economic Outlook No. 85*, 2009, Chapter 4

payment.[45] While it is unlikely to be possible to recoup all of this lost revenue, some movement in this direction is likely to reduce the need for raising tax revenues via new announcements.

Chart 15 shows projected government revenues in 2010-11 by source. From the perspective of criterion three above, it highlights the importance of the three biggest taxes: income tax, National Insurance and VAT together account for 59 per cent of the total. As such, while reform of other taxes may be important from the perspective of removing distortion or improving redistribution, they are less likely to make a sizeable contribution to closing the deficit.

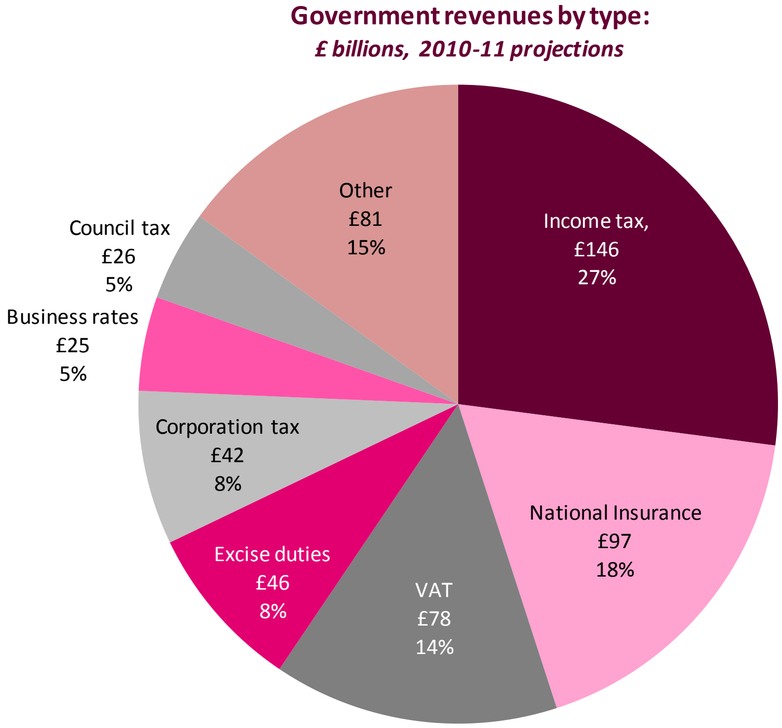


Chart 15: **Projected government revenues by type: UK 2010-11**

Note: Other receipts include capital taxes, stamp duties, vehicle excise duties, and some other tax and non-tax receipts- for example interest and dividends.

Source: HMT, *Budget 2010*, Table C6

According to the OECD, in terms of impact on economic growth, the most distortionary forms of taxes are corporate, followed by personal income taxes and then consumption taxes such as VAT. The least-bad taxes are recurrent taxes on immovable property. In the UK, a focus on such taxes may also help to reduce the housing and stock market speculation that contributed to the economic crisis.

In terms of distributional impact, it is important to view the final package in the round – increases that impact on one group may be compensated by reduced tax

[45] The Green New Deal Group, *The Great Tax Parachute: How to save the public finance and keep the economy afloat*

or increased benefits elsewhere. Generally speaking, direct taxes such as income tax and National Insurance are progressive, while indirect taxes such as VAT tend to be regressive. From a low earner perspective, therefore, direct tax rises are likely to be less bad than indirect tax rises.

Corporate taxes are harder to assess. The Volterra study discussed above assumes that they are passed onto consumers in the form of prices, and therefore are likely to fall on households in a similar way to consumption taxes. In truth, firms are likely to internalise some of these taxes, meaning that part of the burden will be absorbed by shareholders and owners who are likely to be at the higher end of the income range. Companies might also choose to react by reducing labour costs, thereby disadvantaging low earners who tend to be most susceptible to job losses and pay restraint. It is difficult therefore to make a definitive assessment.

Wealth is more unevenly distributed than income, with the wealthiest 10 per cent of the population owning more than half of the nation's marketable wealth.[46] Wealth taxes are therefore likely to be more obviously progressive. Given that government intervention following the start of the credit crunch and economic crisis is likely to have helped maintain the value of a range of assets, it could also be argued that it is fair to now ask owners of those assets to pay a larger portion of the repair bill. While it is not possible to state definitively that all low earners would benefit from additional focus in this area – because some members of the group may be income-poor but asset-rich – the group as a whole is unlikely to be disproportionately affected.

3.4.3 Principles for cutting spending

A common theme in the literature on good principles of consolidation is the need to avoid salami-slicing, with across the board cuts to all services without any priorities being set. Several commentators argue that such an approach leads to ministers taking defensive – rather than conciliatory – stances, and that cuts are heaviest on services that fall between departments and on those that are unfashionable. As discussed in Section 2.5, adopting this methodology would be likely to hit hardest those who currently use public services most intensely.

PwC has developed a framework by which government activity can be assessed as part of a zero-based review.[47] It proposes asking two questions of state spending:

- What is the relative importance or priority of each area of spend?

---

[46] HMRC, *National Statistics*, Table 13.5. The IFS has suggested that this figure may understate the level of inequality because the data omits occupational and state pension wealth, human capital and because it fails to capture assets given as gifts during lifetime as a means of avoiding inheritance tax.
[47] PwC and Demos presentation, "Budgeting in an age of progressive austerity: A framework for revenue and spending", November 2009

- How effective is the public sector at delivering different services?

Activities that are high priority and delivered effectively should continue (and may even be increased), while areas that are low priority and delivered inefficiently should be cut, with any valuable assets sold off. Activities falling somewhere between these two extremes could be candidates for outsourcing, reform or the introduction of user-charging.

This two-stage process effectively meets the two criteria of fairness and sustainability discussed above, and appears to be reflected in the approach set out in the new Government's Spending Review process (see Section 1.3.4). However, it highlights the fact that Government commitments to protect 'the front-line', while well-intentioned, produce a bias that is not helpful. Instead, a zero-based review would put everything on the table. Having undertaken this systematic consideration, the vast majority, if not all, existing front-line services may still be spared from cuts, but a full debate about the purpose and role of government will have been had which will help to crystallise thinking about genuine priorities.

Chart 16 highlights a further difficulty with protecting some front-line services, namely that health and expenditure comprise such a large proportion of all government spending. Together they are expected to account for nearly one-third of the 2010-11 total. The other major area of expenditure is social protection, which is projected to amount to £196 billion in 2010-11, 28 per cent of all spending.

Just as the necessity of raising more in taxes could help drive fundamental reform of the system, so the search for spending cuts should be tied to wider consideration of the way in which funding works. This goes further than simply identifying efficiencies within separate areas. The Institute for Government paper on principles of good consolidations recognises the gains made in other countries as lower tiers of government innovate in the face of lower budgets. However, it notes that the relatively centralised structure of UK government produces budget silos which could instead produce a retreat to delivering core services among public services. It therefore calls for an explicit focus on joining up these silos, learning the lessons of the Total Place pilots to develop a 'whole area' approach that provides better public services at a lower cost.

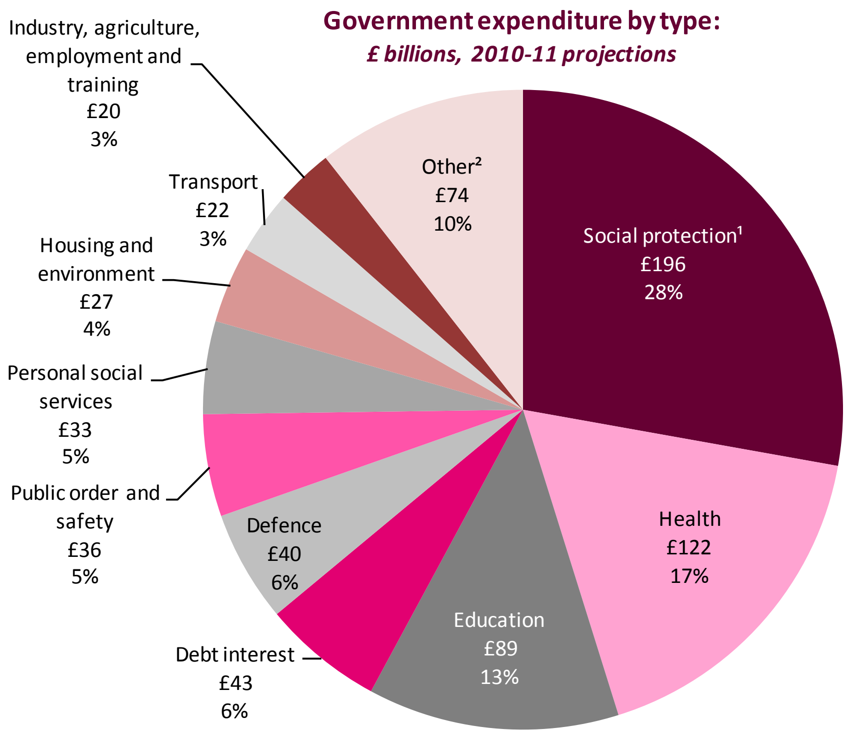


Chart 16: **Projected government spending by type: UK 2010-11**

Notes: [1] Includes tax credit payments in excess of an individual's tax liability, which are now counted in AME, in line with OECD guidelines.
[2] Includes spending on general public services; recreation, culture and religion; international cooperation and development; public service pensions; plus spending yet to be allocated and some accounting adjustments.

Source: HMT, *Budget 2010*

3.5 Conclusions

As we concluded in Section 1, fiscal consolidation of sorts is unavoidable in order to get to grips with the public sector deficit. To this end, we are pleased that the new Government intends this year to both set out its broad timetable for tightening and detail specific actions for reducing the deficit over the lifetime of the current Parliament.

In designing its timetable and detailed route map, the Government should have consideration for three criteria: *fairness*, *growth* and *sustainability*. Fairness has obvious implications for low earners, but growth also matters to the group: with direct and indirect support from the state much-reduced, employment prospects for low earners will become even more important. Low earners will benefit from a regard for sustainability because of the importance of ensuring the consolidation process proves successful. By presenting a final plan as a single package, the Government can highlight the trade-offs between these criteria and between different groups in society, to make it clear how the pain of adjustment is being shared.

From the perspective of fairness, the pace of fiscal tightening should be made contingent on the state of the economy, because any return to recession provoked by the withdrawal of government activity would once again fall heaviest on low earners. This contingency could take the form of inclusion in the timetable set out in the emergency Budget of a series of tests designed to assess whether the private sector has gained self-fulfilling momentum, along with details of how the Government might react to domestic and global economic performance and events that are outside of its central forecasts.

From the perspectives of growth and sustainability, there should be equal flexibility to accelerate deficit reduction if the economy performs better than expected. Commitment to this would both reassure investors that the Government is serious about tackling its fiscal problem and help to ensure that the total period of painful adjustment is kept to a minimum.

Spending cuts are expected to account for the majority of the fiscal tightening, However, there is clearly still a role for closing some of the deficit via raising tax revenues. This role stems from both the economic reality that the size of the hole is such that spending cuts can only take so much of the strain, but also from the likely political reality of the limits of public acceptance of cuts in services. Fairness dictates that the mix of mechanisms should be designed to ensure that low earners are not disproportionately affected by the adjustment. For the group, what is of most importance is not the split between tax and spending, but the balance between progressive and regressive approaches: some tax increases can act in a regressive way, while some spending cuts could be broadly progressive.

In terms of growth, economic theory and evidence from past consolidation episodes suggests that adjustments that place a greater reliance on spending cuts than on tax increases are more likely to be beneficial, and the new Government is committed to such an approach. To this end, while cuts in areas of current spending are likely to be particularly difficult for low earners, they should not be avoided simply by cutting investment in the future of the economy. Similarly, tax policies should be selected with reference to keeping disincentives and distortions to a minimum.

In order to ensure that any cost-cutting and revenue-raising measures introduced make headway into the structural deficit, it is important that they are designed with sustainability in mind. This means tackling some of the big areas of spending and revenue – health, education, income tax and VAT for instance. It also means taking the opportunity for reform alongside fiscal adjustment: reform of tax mechanisms and reform of public service delivery. Such restructuring could both improve the efficiency of taxes and spending, and so help the process of closing the deficit, and improve the interaction that all citizens, including low earners, have with the machinery of government.

4 Low earner impact assessment

In Section 3 we argued that the Government should have consideration for fairness, growth and sustainability in developing its fiscal consolidation plan. To assist in this process, we consider in this section the fairness of a range of specific proposals advanced for closing the deficit – from the obvious and immediate, to the more controversial and complex – by politicians, think tanks, academics and other commentators. While a number of these stakeholders have attached their own assessment of the distributional impacts of their policy suggestions, concern has rarely been expressed for any outcome other than protecting the poorest and most vulnerable while avoiding damaging growth by over-burdening the rich. What follows attempts to provide a more detailed impact assessment from the perspective of low earners.

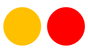
As discussed in the previous section, what matters to low earners in terms of fairness is the overall balance of any consolidation package. In order to help policy makers consider the needs of the group when putting together a final plan, we set out here colour-coded assessments of approaches across the three themes of tax, welfare and public services. The key is set out below, and Appendix 1 provides a summary of the findings. It is not our assertion that all 'red' options should be avoided, simply that the overall package needs to be appropriately balanced.

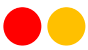

Low earners unaffected, or significantly less affected than other income groups

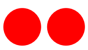

Low earners little affected, or less affected than other income groups


Low earners slightly less affected than other income groups


Broadly neutral distributional impact/not possible to make an assessment


Low earners slightly more affected than other income groups


Low earners quite affected, or more affected than other income groups


Low earners significantly affected, or significantly more affected than other income groups

4.1 Tax

As discussed in Section 3.4.2 , direct taxes such as income tax and National Insurance are, generally speaking, progressive, while indirect taxes such as VAT tend to be regressive. Attempts to raise revenues from the former are therefore likely to be preferable to those that focus on the latter from the perspective of low earners. Corporate taxes are harder to assess, and are therefore largely considered to be distributionally neutral here, while taxes on wealth are invariably progressive but raise relatively little revenue.

The assessments set out here consider revenue-raising options only. Clearly, some tax cuts could benefit low earners and help compensate for the impact of other consolidation measures. For example, the Government's decision to raise the income tax personal allowance has the potential to boost the incomes of a significant number of low earners – and is therefore welcome. However, we have chosen not to consider such options because of the need for offsetting tax increases and spending cuts that these would produce.

4.1.1 Direct taxes

Chart 15 highlighted the importance of direct taxes to the total UK tax-take: income tax and National Insurance are expected to account for around 45 per cent of all revenues in 2010-11. As discussed above, direct taxes can create disincentives for work, investment and saving, and can therefore affect economic growth. However, they are funded from a broad tax base and are generally progressive. Therefore, from the perspective of low earners they tend to be less bad than some other forms of taxation.

Table 7 showed that there are 7.1 million working low earners: 6.0 million employees and 1.1 million self-employed. Around 1.1 million of these 7.1 million do not pay income tax, while 6.0 million pay at the basic rate.[48] Only a very small number of low earners are likely to be higher rate payers.

Similarly, around 1.3 million working low earners do not earn enough to pay employee National Insurance contributions (or Class 2 and Class 4 contributions for the self-employed) and around 5.8 million pay the main rate (11 per cent for employees, 8 per cent plus a flat fee for the self-employed). Very few low earners are above the Upper Earnings Limit.

[48] Based on analysis of the earnings of single person low earners households using ONS *Family Resources Survey 2007-08* data.

Increasing income tax rates

Income taxes (gross of tax credits) generated £153.4 billion in 2008-09.[49] According to the Treasury's *Tax Ready Reckoner*, an increase in the basic rate of tax from 20p to 21p in April 2011 would raise around £4.05 billion a year, an increase in the higher rate from 40p to 41p would raise £0.95 billion and an increase in the additional rate from 50p to 51p would raise £0.55 billion.[50] However, the estimates for the higher and additional rates include no assumptions of behavioural change. In reality, revenues might be expected to be lower. The IFS believes that any increase in the additional rate would be unlikely to raise any extra revenue.[51]

Any increase in the basic rate from 20p would affect all income tax payers. It would reduce net incomes among low earners, but would be broadly progressive, with higher earners experiencing bigger proportional falls in net incomes. However, because all higher rate taxpayers would lose the same cash amount, the richest ten per cent of the population would experience a smaller proportional drop than those in income deciles 8 and 9.

Increasing the higher rate only would affect very few low earners: indeed, the vast majority of income would be raised by the richest ten per cent of the population. However, the rate would need to increase by more than 4p to raise the same level of revenue as a 1p increase in the basic rate (the rate might need to increase by even more to offset any behavioural change). Similarly, increasing the additional rate would impose a cost on only the richest members of society, but would be unlikely to raise much, if any, money.

A purely progressive outcome could be achieved by increasing both the basic and higher rates, with the additional revenue raised by increasing the higher rate helping to reduce the amount by which the basic rate would need to be increased to secure a specific level of revenue.

Table 6 showed that low earners already tend to live at the edge of their means. Therefore, any measure that reduces their income is likely to pose difficulties. However, given that some revenue *has* to be raised, the progressive choice of collecting more in income tax appears to be among the least-bad options, particularly as the size of the revenues that could be achieved by increasing both the basic and higher rates by a few pence mean that some funds could be used to compensate low earners via alternative means (such as tax credits).

---

[49] HMT, *Budget 2010*, Table C6
[50] HM Treasury, *PBR 2009 – Tax ready reckoner and tax reliefs*, December 2009, Table 4
[51] IFS Briefing Note 84m *Can more revenue be raised by increasing income tax rates for the very rich?*, 2009

Introducing local income tax

Below, we discuss the disproportional impact that the current council tax structure has on low earners. One means of replacing this mechanism would be the introduction of local income taxes, designed either to raise the same revenue as council tax does currently or to increase receipts beyond this level in order to reduce central government spending on local authority grants.

The precise distributional impact would depend on how the tax was established – the various rates and allowances – and would vary by area. However, assuming that rates were set in a progressive manner, the principle would be broadly similar to that set out above, namely that higher earners would pay more as a proportion of their income. Low earners would thus be similarly affected, although individual members of the group may experience significant increases or decreases in their local tax bill, depending on their circumstances.

Increasing the starting rate for savings income

Increases in income tax rates generally have the same effect on income from savings (interest from bank and building society accounts) as on earned income. However, the removal of the 10p starting rate of income tax in April 2008 applied only to earned income, meaning that a portion of savings income continues to be taxed at the lower rate. Removal of the 10p rate would raise £0.1 billion in 2011-12 according to the *Ready Reckoner*, although this figure would rise if interest rates increased.

There is a good argument for implementing such a policy, because the current arrangements add significant complexity to the income tax system, requiring eligible individuals to apply for rebates. However, the burden of this measure would fall entirely on those with the lowest incomes, including some low earners.

It would be better instead to remove taxes on savings income altogether because they distort decisions between spending income now and in the future. However, this would cost money at a time when the Government needs to close the budget deficit. The least-bad option would therefore be to retain the current 10p starting rate.

Cutting income tax thresholds

According to the *Ready Reckoner*, cutting the income tax personal allowance by £100 from its level of £6,545 in 2010-11 would raise £0.65 billion a year, cutting the basic rate limit by 1 per cent from £37,400 would raise £0.25 billion and cutting the higher rate limit by 1 per cent from £150,000 would raise £0.05 billion. Again these figures take no account of any behavioural changes.

As with income tax rates, most revenue is raised by altering the threshold which affects the largest number of taxpayers, namely the personal allowance. Cutting the allowance would impact on all existing taxpayers and increase the total base, reducing incentives to work – particularly for low earners.

Analysis from the IFS suggests that cutting the personal allowance is a less progressive means of raising revenue than increasing the basic rate.[52] This is because all basic rate taxpayers would lose out by the same cash amount. For example, if the threshold was cut by £1,000, all basic rate taxpayers would pay an additional £200 in tax (20 per cent of the value of the threshold cut), which would be worth proportionally more to those basic rate tax payers with the lowest incomes. Similarly, all higher rate taxpayers would lose out by the same cash amount (£400, or 40 per cent of the threshold cut), meaning that lower earning higher rate payers would lose more on a proportional basis. Those earning more than £112,870 would experience no effect, because the personal allowance is already reduced to zero above this income. Clearly, the Government's commitment to increasing the personal allowance over the course of the Parliament means that this approach is unlikely to be adopted in any event.

Reducing the basic rate limit would have no effect on basic rate tax payers other than those who find themselves pushed into the higher band by the move. These individuals would be particularly disadvantaged because the adjustment would again have a flat cash cost, meaning that those just above the new limit would lose more as a proportion of their pay than those with higher incomes. Reducing the higher rate limit would have no effect on low earners, but would raise only a small amount.

Given that cutting thresholds is less progressive than increasing rates, it is a less favourable option for low earners, even if it is politically easier to achieve because of the option of employing fiscal drag, whereby thresholds are held constant in nominal terms despite rising wages.

Removing personal allowance for higher rate income tax payers

The Labour Government's decision to phase out the personal allowance for those earning above £100,000 a year creates a small band between this salary and the higher rate limit of £150,000 a year which faces marginal tax rates of 60 per cent (not including National Insurance contributions), rather than the 50 per cent rate paid by those earning above £150,000. This anomaly could be overcome by removing the personal allowance for *all* higher rate tax payers. The IFS has estimated that such a policy would raise £4.1 billion in 2011-12.[53]

[52] IFS, *Green Budget*, February 2010, p141
[53] Ibid, p142

Such a move could be considered 'fair' because any increase in the personal allowance is currently worth twice as much to higher rate tax payers as it is to basic rate tax payers. That is, because their marginal tax rate is 40 per cent rather than 20 per cent, they gain 40p for every £1 increase in the allowance rather than 20p. This option would therefore leave low earners largely untouched. However, it would add to the complexity of the system and would reduce incentives to earn more for those low earners close to the basic rate limit.

An alternative solution could be to reduce the basic rate limit by a corresponding amount each time the personal allowance is increased. In this instance, for every 40p higher rate payers gain from an increase in the personal allowance, they must pay 40p more tax at the higher rate. As such, basic rate tax payers – including low earners – would be the only ones who gain from an increase in the personal allowance. However, this would drag more low earners into paying the higher rate and would produce large marginal tax rates for some unless the National Insurance Upper Earnings Limit was reduced at the same time. Note also that such a move would not raise revenues, but would instead reduce the cost of future increases in the personal allowance, including the increases planned by the new Government.

Removing pensioner tax allowance

The personal allowance for those aged 65-74 is £9,490, rising to £9,640 for those aged 75 and over. Both allowances are reduced by £1 for every £2 of income the individual has above a threshold of £22,900, until the allowance reaches the same level as that for younger people (£6,545). In addition, married couples in which at least one partner is aged 75 or over are eligible for a further allowance of £6,965, which takes the form of 10 per cent tax relief on either individual's tax bill (meaning that it is worth £696.50). This allowance is also reduced as income rises, but never falls below £2,670.

The income-related withdrawal of these allowances means that marginal tax rates rise from 20 per cent to 30 per cent for some pensioners, before falling to 20 per cent again. Therefore, removing them would help to simplify the tax system and smooth out this bump. The IFS estimates that such a move would raise £2.8 billion a year in 2011-12.[54]

However, because these higher allowances are restricted to those pensioners with incomes below £30,000, the revenue raised from their removal would be drawn almost entirely from low earners. Any move to compensate those who lose out via Pension Credit or increases in the Basic State Pension would be difficult to

[54] Ibid, p152

target. Instead, the various allowances could be aligned by increasing the limit for younger people as the Government has proposed.

Restricting pension contribution tax relief

The Labour Government introduced legislation to restrict tax relief on pension contributions for those with very high incomes from April 2011. The IFS has estimated that a broadening of this policy to restrict tax relief on pension contributions to 20 per cent for all higher rate tax payers would raise an additional £4.1 billion a year, although it acknowledges that behavioural changes could reduce this figure considerably.[55]

This policy would affect very few low earners, because basic rate tax payers would experience no change in their rate of tax relief. It is also potentially fairer, to the extent that some individuals currently get relief at 40 per cent on pension contributions but then only pay 20 per cent on their pension income.

However, for those individuals who will achieve a pension income significant enough to be liable for 40 per cent income tax, this move would impose a penalty. It would therefore reduce the attractiveness of saving in a pension for these individuals. Depending on the number of people affected, demand for pensions could fall to such an extent that providers must reduce returns for those individuals who continue to save with them. This could then have a negative impact on low earners.

A further disadvantage is the level of complexity this proposal would introduce to the system because of the difficulty of calculating contributions to defined benefit schemes. The compliance costs for scheme organisers and members could again impact on low earners.

Reducing limit on tax-free lump sum pension drawdown

Private pension holders can currently take 25 per cent of their fund as a tax free lump-sum when they retire. The IFS estimates that this measure meant that around £3.2 billion of tax was foregone in 2008-09, with individuals able to access tax free funds of up to £437,500. The tax free lump-sum represents one of the key attractions of investing in a pension, so outright removal of this right would be likely to have a very significant impact on saving behaviour. However, the amount that could be drawn down in this way could be limited, in order to retain the pension tax-advantage while raising some extra revenue.

Among non-retired low earners, 17 per cent have a personal pension and 32 per cent are members of occupational schemes; among higher earners these

[55] Ibid, p150

proportions rise to 27 per cent and 67 per cent respectively.[56] Low earners are therefore less exposed than higher earners to any change in the lump-sum rules. However, given that those low earners who *do* have private pensions are more likely than higher earners to have relatively small pots, they might find it more difficult to deal with a reduction in the amount that they can access at retirement. Therefore, it would be better to impose an upper cash limit (of, say, £25,000) on the lump-sum rather than reducing the proportion that is available from 25 per cent.

Increasing National Insurance rates

National Insurance contributions generated £96.6 billion in 2008-09.[57] The *Ready Reckoner* includes estimates for revenues associated with increasing employee and employer National Insurance contributions. An increase of 1 percentage point in the 11 per cent employee main rate in 2011-12 would raise £4.05 billion, an increase of 1 percentage point in the 1 per cent additional rate would raise £1.0 billion and an increase of 1 percentage point in the 12.8 per cent employer rate would raise £5.15 billion.

Given that employer contributions are likely to be passed onto employees, either in the form of lower wages or lower employment, the distributional impacts of changes in either are likely to be broadly the same. From the perspective of both distribution and incentives, an increase in either rate would have the same effect as increases in income tax rates, meaning that the option has the same outcome for low earners. The main difference is that the retired would be unaffected, because National Insurance is not payable on earnings from savings.

In relation to employee contributions, an increase in the main rate only would affect all National Insurance payers in a broadly progressive way, while an increase in the additional rate only would be restricted to those earning above £43,875 but would raise significantly less money. An increase in both the main and additional rates would be entirely progressive and would reduce incentives to work slightly.

Rates for the self-employed are lower. The *Ready Reckoner* states that increases of 1 percentage point in the 8 per cent main Class 4 rate and 1 per cent additional Class 4 rate would raise £0.54 billion in 2011-12, while a £1 per week increase in the Class 2 rate would raise £0.16 billion. Any effort to equalise the treatment of employees who are contracted out of the state second pension and the self-employed would raise £6.8 billion a year, but would be likely to lead to a considerable change in behaviour and reporting of income that would reduce the yield. As with employee contribution rates, any increase in self-employed rates

[56] Resolution Foundation, *Low earners audit*, March 2010, Chart 60
[57] HMT, *Budget 2010*, Table C6

would be progressive, but if rates are equalised, it would pose a significant burden for the 1.1 million self-employed low earners.

Cutting National Insurance thresholds

Cutting employer and employee National Insurance thresholds would have very similar effects to reducing the income tax personal allowance. That is, it would be a less progressive option than increasing rates. The *Ready Reckoner* estimates that a reduction in the employee and employer entry thresholds by £2 a week would raise £0.65 billion a year in 2011-12.

There is an argument for cutting the employee contribution threshold to equalise it with the income tax personal allowance and so remove some complexity from the system. However, it would be preferable to instead raise the personal allowance in line with the employee threshold and offset the cost by raising funds through some more progressive means.

Again, freezing the thresholds and counting on fiscal drag is likely to represent a politically more acceptable option than explicitly increasing National Insurance contributions but, as with cutting the personal allowance, this tactic would not benefit low earners.

Increasing National Insurance Upper Earnings Limit

Increasing the Upper Earnings Limit from its rate of £844 a week in 2011-12 to £854 a week would result in more people paying the main rate of 11 per cent, and would raise £0.13 billion according to the *Ready Reckoner*.

In reality, such an incremental increase would create a perverse schedule of marginal tax rates for those higher rate income taxpayers just above the basic rate threshold. That is, their marginal rates would jump to 51 per cent (40 per cent income tax and 11 per cent National Insurance), while those remaining above the Upper Earnings Limit would retain marginal rates of 41 per cent (40 per cent income tax and 1 per cent National Insurance).

This situation could be avoided if the basic rate limit was increased in line with the Upper Earnings Limit increase, but this would impose a net cost on the Treasury because it would reduce the number of higher rate tax payers. Instead, a revenue-raising change in the Upper Earnings Limit would require an increase to £100,000 a year. This would have the same effect as increasing the higher rate of income tax to 50p for everyone (40 per cent income tax and 11 per cent National Insurance rather than 50 per cent income tax and 1 per cent National Insurance). The IFS has calculated that such a move would raise around £4.2 billion in 2011-12.[58] It would

[58] IFS, *Green Budget*, February 2010, p145

mean, however, that all higher rate payers would face high marginal tax rates, and would create a cliff-edge between basic rate payers and higher rate payers that would represent a big disincentive for some low earners.

Removing exemption of employer pension contributions from National Insurance

Contributions to a personal pension made by an employee are subject to National Insurance, but employer contributions are not, meaning that they are a very tax-favoured way of saving. According to the *Ready Reckoner*, this exemption cost £8.3 billion in 2009-10. If it were removed, it is unlikely that it would generate as much because of behavioural changes. Nevertheless, the revenue raised would be significant.

This approach would also suffer from the same issues of complexity and compliance costs associated with restricting pension tax relief to 20 per cent for higher rate tax payers, meaning that low earners could suffer from a general reduction in pension returns.

An alternative approach is to exempt pension contributions from National Insurance, but subsequently charge National Insurance on pension payments. This would require a staged approach to prevent pensioners who had not benefitted from National Insurance exemptions from paying the tax in retirement. It would also create a problem in determining how an employer contribution could be paid at the point at which the employee draws their pension because the employer may no longer exist.

Although there is nothing to suggest that low earners would be more or less likely than higher earners to suffer from the removal of the employer contribution exemption, the level of pension inadequacy among members of the group means that any policy that reduces overall pension saving is likely to have particularly difficult consequences for them.

4.1.2 Indirect taxes

Chart 15 showed that VAT and excise duties are expected to provide 22 per cent of tax revenues in 2010-11, reflecting the broad tax base. As discussed above, indirect taxes are considered to be less harmful for economic growth than direct taxes are. However, indirect taxes tend to be less progressive, and in some instances regressive, meaning that they are likely to fall more heavily on low earners than direct taxes do.

Table 6 showed that low earner households spent all of their weekly disposable income on average prior to the recession. Therefore, faced with increases in indirect taxes that effectively increase the cost of goods and services, most low earners are unlikely to have any option but to reduce their consumption.

Increasing standard rate of VAT

VAT generated £78.4 billion in 2008-09.[59] The *Ready Reckoner* states that a 1 percentage point increase in the standard VAT rate of 17.5 per cent would raise £4.5 billion a year in 2011-12. In addition to raising a significant sum of money, such a move has a number of tactical advantages.

First, consumption taxes are less likely to distort incentives to work and save than changes in direct taxes. It is therefore less likely to impact on economic growth prospects. Secondly, it is a relatively straightforward change and is likely to be quite fast acting. Third, if a future VAT increase is pre-announced, consumers are likely to bring forward some purchases, helping to boost economic recovery in the current year while still signalling intent to capital markets that the Government is serious about acting on the deficit.

From the perspective of fairness, indirect taxes tend to place a higher burden on low earners than on higher earners. The IFS has posed a different perspective on VAT however. It suggests that, while VAT is regressive when households are ranked in terms of income, it is mildly progressive if households are ordered on the basis of total expenditure. Its reasoning for adopting this approach is that annual expenditure better reflects a household's lifetime income, because those households that expect a fall in their future income will be more likely to reduce expenditure in order to save some money for future years, while those households that expect an increase in their future income are more likely to borrow against this outcome in order to boost consumption in the current year.[60]

Households move in and out of the low earner group over the course of their lifetimes. The IFS expenditure approach goes some way to taking account of this, and suggests that an increase in the standard rate would not be as bad an option for lifetime low earners as might be considered in conventional analysis. However, even on an expenditure basis, the tax is less progressive than any attempt to raise revenue via direct taxes.

Increasing reduced rate of VAT

Certain items, primarily domestic fuel and power, are subject to a reduced rate of 5 per cent VAT. The *Ready Reckoner* estimates that a 1 percentage point increase in the rate would generate £0.31 billion a year in 2011-12, meaning that removing the reduced rate altogether and charging the standard rate on all eligible items would raise £3.9 billion.

[59] HMT, *Budget 2010*, Table C6
[60] IFS, *Green Budget*, February 2010, p147

In addition to raising revenue and conferring some of the same benefits as those detailed above in reference to increasing the standard rate (although it is less likely to cause households to bring forward purchases because fuel is used as it is needed), this approach would have the added advantage of removing some of the distortion in expenditure patterns towards goods that are more favourably treated.

Table 6 showed that low earners spend a much higher proportion of their weekly income on fuel than higher earners, meaning that such a move would disproportionately fall on the group. Analysis from the IFS confirms that extending the standard rate to reduced rate items would be regressive, whether households are ranked in terms of income or expenditure.[61]

Introducing VAT to zero-rated items

Other items, including food, children's clothes, domestic passenger transport, books, newspapers, magazines, water and sewerage services and prescription drugs are currently exempt from VAT. Introducing a charge would work in a very similar way and have very similar effects to increasing the reduced rate as discussed above. Applying the standard rate to all zero-rated goods would have raised £24.75 billion in 2009-10 according to the *Ready Reckoner*. Applying the standard rate to *all* goods and services (including those that are currently charged at the reduced rate) would have generated an additional £28.75 billion in 2009-10.

The arguments for and against such an approach are very similar to those set out above in relation to increasing the reduced rate. However, given the very substantial sums that would be raised, there does appear to be scope for compensation of those at the lower end of the income spectrum via increases in benefits and tax credits. For example, the IFS has designed compensatory packages for poorer households, households with children, those with disabilities and pensioners that would still produce a net gain of £10 billion.[62] However, the danger with this approach is that it reduces the burden for some low earners, but leaves others significantly worse off.

Extending VAT to financial services

Currently, financial services are exempt from VAT in the UK and most other countries, but discussions are being held in the EU and IMF about the prospect of introducing a charge. According to the *Ready Reckoner*, the existing exemption from the standard rate cost £2.8 billion in 2009-10. In reality however, there are significant difficulties associated with introducing VAT to financial services, not

[61] Ibid, p147
[62] IFS, *Green Budget*, February 2009, pp208-212

least determining the level of value added associated with products such as personal loans.

It is difficult to assess precisely what effect this approach would have on low earners. To the extent that financial services firms internalised the tax, we might expect the burden to fall primarily on shareholders drawn from higher earner households. However, some of the burden might be passed onto financial services staff in the form of lower salaries, potentially affecting the 1.2 million low earners working in this sector. Similarly, low earner consumers would be negatively affected by any attempt to pass on the tax in the form of higher prices, particularly given that the credit crunch has already reduced access to such products among members of the group.

On balance however, it seems unlikely that low earners would be affected disproportionately by an extension of this kind.

Increasing alcohol and tobacco duties ●●

Alcohol and tobacco duties together raised £16.7 billion in 2008-09.[63] Duties on cigars and hand-rolling, other smoking and chewing tobacco are charged according to weight. The tax on cigarettes is based on a percentage of the recommended retail price, plus a specified charge per 1,000 cigarettes. Budget 2010 increased tobacco duties by 1 per cent above inflation, and committed to a future escalator of 2 per cent above inflation. The *Ready Reckoner* estimates that a further 1 per cent increase in all tobacco duty (the specific and ad valorem elements together) would raise around £0.13 billion a year in 2011-12.

Duties of different types of alcohol also vary. Spirit duty is charged on each litre of pure alcohol contained in the drink in question. Wine duty is charged on each hectolitre of the product, with different rates applying depending on the strength of the drink. Beer duty is charged on each hectolitre per cent of alcohol in the product. Budget 2010 increased alcohol duties by 2 per cent above inflation, and announced a continuation of this escalator until 2014-15. It also increased duty on cider by 10 per cent above inflation, although this proposal failed to make it through wash-up prior to the election. The *Ready Reckoner* estimates that an additional 1 per cent increase in each of the main alcohol duties would raise just £0.06 billion a year in 2011-12.

Although duties on tobacco and alcohol help to capture the social and health externalities associated with smoking and drinking, they are regressive. Table 6 showed that low earners spend 3 per cent of their weekly disposable income on alcohol, tobacco and narcotics on average, compared with 2 per cent among higher earner households. In relation to alcohol alone, the proportions are 1.1 per

[63] HMT, *Budget 2010*, Table C6

cent and 0.9 per cent; while in relation to tobacco the difference is even more marked, with low earners spending 1.1 per cent of their weekly disposable income on such products on average, compared with 0.5 per cent among higher earners.[64]

Those in the lower half of the income distribution are more price sensitive than higher earners, and therefore more likely to cut back consumption of tobacco and alcohol in response to increases in duties. Depending on the size of this sensitivity, the level of regressivity of these taxes will be reduced: in theory, the duties could be set sufficiently high to cause a reduction in consumption among poorer households that entirely offsets the increases in duties, making the taxes progressive instead.

While a similar argument can be made in relation to all consumption taxes, the perceived dangers of tobacco and alcohol – compared with eating for instance – make the argument more compelling in this instance. Poorer households could potentially achieve a number of additional benefits – in terms of general improvements in wellbeing and in reduced costs in other areas of their lives (laundry bills, dental products and treatments etc).

The evidence is mixed.[65] It is likely that incremental changes will continue to be regressive, without raising much revenue. They will therefore play little part in closing the deficit, while continuing to fall more heavily on low earners than on higher earners. More substantial increases in duties could produce a situation in which higher earners pay a higher share of the tax, but it would be unwise to undertake an experiment in this area without conducting more research. Even if the level of duties that were appropriate for creating a progressive tax could be determined, some low earners would not display the price sensitivity expected of the group as a whole, and would instead suffer a significant drop in income. In addition, if substantial increases in duties reduce consumption, overall revenue may fall, thus defeating the object of change for the sake of deficit reduction.

On balance, while there may be a case to make for further increases in tobacco and alcohol duties to internalise the various externalities associated with the products, we do not feel they should be employed for purely revenue-raising purposes because of the disproportional effect this would have on low earners.

---

[64] Analysis of ONS, *Family Spending 2009*, Table A8. Figures do not sum to total in Table 5 due to rounding.

[65] See Dahlia K. Remler, "Poor Smokers, Poor Quitters, and Cigarette Tax Regressivity", *American Journal of Public Health*, February 2004, for a fuller discussion.

Increasing fuel duties

Fuel duties (petrol and diesel) raised £24.6 billion in 2008-09.[66] This is equivalent to more than half of the total revenue expected from excise duties in 2010-11, as shown in Chart 15.

The main rate is 57.19p per litre for both ultra-low sulphur petrol and ultra-low sulphur diesel, though it is set to rise by 1p per litre on 1 October 2010 and by a further 0.76p per litre on 1 January 2011. Under existing plans, the duty will rise by 1p per litre in real terms on 1 April each year from 2011 to 2014.

The *Ready Reckoner* estimates that an additional 1p per litre change in the main rate in April 2011 would raise around £0.5 billion a year. Such an approach would fall relatively heavily on low earners. Expenditure on transport fuel within the group accounts for an average of 5.8 per cent of weekly disposable income, compared with 3.9 per cent in the higher earner group and 3.2 per cent in the benefit-dependent group.[67] This suggests that, while fuel duties are not regressive across the entire income distribution, they fall more heavily on low earners than on other income groups.

Moreover, the IFS has argued that the rate may already be at the level appropriate to cover motoring externalities (climate change, noise, accidents, air pollution and congestion).[68] It contends that the full costs of congestion in some urban areas may not yet be compensated for, but that fuel duties are a poor instrument for this because they are unable to target localities.

Extending congestion charging and road pricing

Instead, the introduction of more congestion charging in affected areas might be a more appropriate approach. From the perspective of the deficit, more general road charging could be used to raise revenue directly for the Government or local authorities, or it could be sanctioned as part of any agreement to privatise the road network.

Research conducted prior to the introduction of the London congestion charge suggests that the initial burden (i.e. prior to any change in road usage) fell most heavily in proportional terms on those at the top end of the low earner group. While average charges as a proportion of income were lowest among benefit-dependent households, those among higher earners were equal to or lower than those faced by low earners.[69] Again this analysis relates to averages: within each

[66] HMT, *Budget 2010*, Table C6
[67] Resolution Foundation, *Low earners audit*, March 2010, Table 52
[68] IFS, *Green Budget*, February 2010, p155
[69] IFS, *The Distributional Effects of the Proposed London Congestion Charging Scheme*, October 2000

income group some households will have been unaffected, while other will have experienced significant impact.

These findings suggest that the introduction of more road pricing schemes is likely to fall disproportionately on low earners. Given our earlier finding about the relatively low level of public transport use in the group, arguments about the compensating distributional benefit of channelling congestion charge revenues into public transport are unlikely to stand up, although measures which reduce the cost of public transport might help to meet a hidden demand within the group.

Therefore, while we accept the merit in introducing congestion charges as a means of reducing congestion, we do not feel such measures should be used for the purpose of revenue raising.

Increasing air passenger duty rates

As currently designed, air passenger duty (APD) is charged on passengers departing from most UK airports. It acts as a proxy for tax on aviation fuel, helps to internalise the costs of other aviation externalities (noise and air congestion for example) and goes some way to compensating for the exemption of domestic aviation tickets from VAT. The rationale behind the first of these purposes will be reduced somewhat once aviation become part of the EU Emissions Trading Scheme (ETS) in 2012, although there will still be a need for some form of aviation fuel tax to cover non-carbon emission externalities.

APD rates are divided into four bands, based on the distance of the destination country from the UK, with longer journeys charged more. In addition, passengers flying in the lowest class available on a flight pay a reduced rate (between £11 and £55), while those flying in anything other than the lowest class pay standard rate (between £22 and £100). The duty raised £1.9 billion in 2008-09.[70]

Budget 2010 confirmed that APD rates would again be increased in line with inflation in November 2010. The *Ready Reckoner* estimates that a further 1 per cent change in each of the rates would raise an additional £0.025 billion a year in 2010-11. There appears then to be little scope for raising significant funds without substantial increases in the applicable rates.

Because APD is a flat cash charge for all passengers within a certain class on a flight, it is regressive in the sense that it represents a larger proportion of the incomes of those passengers with the lowest incomes. However, this effect is somewhat balanced by the additional charge placed on those flying in premium classes and by the fact that higher earners take more flights (higher earners spend

[70] HMT, *Budget 2010*, Table C6

a slightly higher proportion of their income on flights than low earners do[71]). Nevertheless, significant increases in rates would be more likely to reduce flight demand among low earners already living at the edge of their means than it would higher earners.

Moreover, there is significant resistance from the tourism industry, which claims that APD reduces GDP in the UK by discouraging visitors. The removal of the need for an aviation fuel carbon tax from 2012 means that a significantly more expensive APD would probably outweigh the costs of externalities (if it doesn't already), meaning that the rate would be at an economically inefficient level. Given the relatively small size of the tax take and the small tax base, APD is not a good candidate for pure revenue-raising. We would therefore suggest that increases should only be considered from an environmental perspective.

The new Government has pledged to move APD from a per-passenger to a per-aeroplane charge. This is designed to provide an incentive for airlines to fill seats rather than running empty flights. It will also bring cargo flights within the scope of the duty, thereby potentially increasing revenues without damaging incentives. Assuming rates on passenger aeroplanes are maintained at the current level, low earners are unlikely to be disproportionately affected by this move.

Increasing other excise duties

A variety of other duties raise relatively little revenue and provide little prospect of making serious contributions to closing the deficit. Taken together, the climate change levy, landfill tax and aggregates levy generated £2.0 billion 2008-09[72] and would raise an additional £0.02 billion a year if all rates were increased by 1 per cent.

These duties are likely to be relatively neutral across the income range, meaning that increases would not impose any disproportional effect on low earners. However, the amounts that might be raised are likely to be too small to warrant much activity in these areas.

Introducing a carbon tax

Many of the duties set out above are environmental taxes, designed to cover the negative externalities associated with greenhouse gas emissions. The replacement of some portion of these duties with a new carbon tax may be more appropriate, because it would provide incentives for those (producers rather than consumers) who can reduce emissions most cheaply.

[71] Analysis of DWP, *Family Resources Survey*.
[72] HMT, *Budget 2010*, Table C6

The IFS has estimated that a uniformly-applied carbon tax (and equivalent auctioning of permits for firms already participating in the EU Emissions Trading Scheme) of £21 per tonne of CO_2 would raise around £13.4 billion (assuming no behavioural response).[73] Some behavioural response is likely, however, reducing the actual revenue raised. In addition, the introduction of a carbon tax would remove the environmental case for some of the duties discussed above, potentially reducing the net additional revenue by around £3.5 billion.

If any new carbon tax applies to the domestic sector, it is likely to prove more regressive than the duties it would replace. This is because of the higher proportion of incomes poorer households allocate to domestic fuel. Table 6 showed that housing, fuel and power accounted for 15 per cent of low earner weekly disposable income on average, falling to 8 per cent among higher earners. Looking at just electricity, gas and other domestic fuels, low earner households spend an average of 5.7 per cent of their income, compared with 3.2 per cent among higher earners.

The IFS estimates that any move to exempt the domestic sector from inclusion in a carbon tax would reduce potential revenues by around £3.1 billion. An alternative approach would be to use some of the additional revenue raised from introducing the carbon tax to compensate those households worst affected by increases in domestic fuel prices. However, in addition to cutting the revenue-raising potential still further, it is likely also to be difficult to target assistance because of variations in energy usage within income bands.

Therefore, while a carbon tax which prices the external costs of emissions into those activities that generate them might be preferable to a collection of duties levied on consumption, it usefulness as a means of helping to cut the deficit is likely to be limited by a number of factors.

Increasing vehicle excise duties

Vehicle excise duty returned £5.6 billion in 2008-09[74] and the *Ready Reckoner* estimates that a 1 per cent increase in all rates would raise just an additional £0.06 billion a year in 2011-12.

There is no definitive evidence on the distributional impact of the duty, and it is likely to differ in rural and urban areas. However, while some low earners might be disadvantaged compared to higher earners by their inability to afford more fuel efficient cars, and equally disadvantaged compared to benefit-dependent households by their reliance on a private car for work, it is probable that higher

[73] IFS, *Green Budget*, February 2010, p156
[74] HMT, *Budget 2010*, Table C6

levels of car ownership – and a tendency towards bigger vehicles – among richer households make this a progressive duty overall.

Therefore, increases in vehicle excise duty would be unlikely to present a disproportionate cost on most low earners. However, the relatively low level of revenue that could be raised in this way means that it is unlikely to contribute much to deficit reduction.

4.1.3 Business taxes

Chart 15 showed that corporation taxes and business rates are expected to generate 13 per cent of all tax revenue in 2010-11. Business taxes are thought to have a strong effect on a country's economic growth, with the most tax-competitive countries tending to grow more quickly. This, and the relatively small size of existing revenues, suggests that there is only limited scope for using business taxes as a means of contributing to closing the deficit. As discussed above, it is not possible to directly allocate corporate tax-take to households, meaning that we cannot be sure what distributional impact raising revenue in this way would have.

Increasing corporation tax rates

Corporation tax is charged on the profits made by companies, public corporations and unincorporated associations such as industrial and provident societies, clubs and trade associations. The main rate of corporation tax is 28 per cent, and is payable by organisations with profits in excess of £1.5 million. Those businesses with profits below £300,000 are subject to the small companies' rate of 21 per cent (this is set to rise to 22 per cent in April 2011), while those with profits between £300,000 and £1.5 million pay the main rate but receive some marginal tax relief.

In 2007-08, 91 per cent of companies paid the small companies' rate, 4 per cent paid the main rate but received tax relief and 5 per cent paid the main rate in full. Those paying the small companies' rate accounted for 20 per cent of total chargeable profits, while those paying the main rate accounted for 74 per cent.[75]

Corporation tax (gross of the tax credits paid to firms) generated £43.7 billion in 2008-09. The *Ready Reckoner* estimates that increasing the main rate by 1 percentage point would raise just £0.8 billion a year, while a 1 percentage point increase in the small companies' rate would raise around half as much, £0.42 billion.

There appears to be limited opportunity to increase the main rate, with statutory rates tending to fall in recent years as countries have sought to gain tax

[75] HMRC, *Revenue-based Taxes and Benefits,* Table 11.3

competitiveness. Any increase in the UK's main rate would increase incentives for firms to move their profits offshore.

There is, however, more scope for increasing the small companies' rate. In order to raise a reasonable sum of money, the small companies' rate could be removed altogether. The *Ready Reckoner* puts the cost of the current discount at £3.2 billion in 2009-10. While increasing the taxes paid by SMEs could have negative consequences in terms of restraining entrepreneurial behaviour and risk-taking, the current description of a 'small company' is likely to include firms that are simply small as well as those that are nimble and risk-taking. The current use of differential tax rates therefore risks producing distortions to the choices made by firms and by investors that could reduce economic growth. The recent introduction of tax credits designed to reward research and development might prove to be a better mechanism for incentivising entrepreneurial activity.

The impact on low earners of such a move depends on the reaction of those corporations affected. To the extent that the firms absorb the additional tax, it is more likely to be higher earners who are affected, in the form of profits. To the extent that the firms restrict wage or employment growth, low earners could be disproportionately affected because those in the lowest paid jobs tend to be most vulnerable to labour market softness. To the extent that firms pass the increased costs associated with higher taxes onto prices, low earners could again be disproportionately affected because consumption taxes are generally regressive.

Increasing business rates

Business rates are levied on the annual rateable values (i.e. market rents) of properties occupied by business. Rateable values are updated every five years, with transitional arrangements smoothing gains and losses associated with this. Exemptions and reduced rates are available for certain types of businesses, including charities, rural shops, agricultural land and empty property. In total, business rates generated £22.9 billion in 2008-09.[76]

Given the relatively low revenues raised via this route, and the potential impact that increases would have on business competitiveness and therefore economic growth, there is likely to be little opportunity to use this mechanism as a means of tackling the deficit. There is, however, some scope for more general reform of the system, because the current arrangements are not related to profitability and, with their focus on property values rather than land values, provide a disincentive to expand or improve buildings.

As with corporate taxes, it is not possible to determine what distributional impact increases in business rates would have. It is likely that some costs would be

[76] HMT, *Budget 2010*, Table C6

absorbed (lower profits) and some would be passed on (lower labour return and higher product prices). The extent to which low earners would therefore be affected would depend on the balance of these reactions. It is unlikely, however, that the group would be particularly disproportionately disadvantaged.

4.1.4 Wealth taxes

As discussed in Section 3.4.2, taxes imposed on immovable property tend to have the smallest impact on economic growth. Indeed, to the extent that increasing taxes on properties can help reduce speculation, such an approach could help rebalance the economy and improve long-term stability. For example, Adam Posen has argued in favour of varying the rates of stamp duty and capital gains over the economic cycle to act as an "automatic stabiliser for housing prices".[77]

Other forms of wealth taxes are likely to have less positive effects. For example, all taxes on investment risk undermining innovation, while those that are imposed on transfers of wealth can hinder the efficient allocation of assets by discouraging mutually beneficial deals. However, the majority of wealth in the UK is held in the form of property and much of it is accumulated passively via rising house prices or inheritance, meaning that it should be possible to target wealth taxes in a way that minimises damage to the economy.

As shown in Chart 15 though, wealth taxes currently account for a relatively small proportion of all revenues, limiting the role they might play in a fiscal consolidation package.

From the perspective of low earners, wealth taxes are likely to be preferable to consumption taxes, because wealth is held very unevenly, with the wealthiest 10 per cent of the population owning more than half of the nation's marketable wealth.[78] The concentration of wealth in the hands of a minority of the population means that wealth taxes may even be more redistributive than direct income taxes. However, because some members of the low earner group are income-poor and asset-rich, a focus on wealth taxes may create difficulties for a minority.

Increasing council tax rates ●●

Central government has limited opportunity to increase council tax rates, because they are set by local authorities. However, the Government could encourage increases by cutting authorities' grants (using the money saved as a means of closing the deficit) and removing or loosening the caps it imposes on levels it

[77] *The Times*, "Bank's Posen calls for housing bubble taxes", 1 December 209
[78] HMRC, *National Statistics*, Table 13.5

deems excessive. Total council tax receipts amounted to £24.4 billion in 2008-09.[79]

Council tax takes no account of incomes. Households (home owners and tenants) are charged flat fees depending on the position of their home within eight house price bands (in England, Scotland and Wales), based on valuations from 1991 (in England and Scotland – Welsh property valuations are from 2003). 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.

Therefore, any increase in council tax take that didn't deal with the underlying structure, would fall disproportionately on low earner households. Given that council tax accounts for a relatively small proportion of all government receipts, any increases designed to help close the deficit would need to be quite large, meaning that low earners could potentially face significant increases in bills.

Introducing ad-valorem tax on all properties

A flat-rate tax on all properties could be introduced, either in its own right or – more conceivably – as a direct replacement for the current council tax structure. The tax would be more progressive than the current council tax because cash payments would reflect the value of the home rather than be flat within specified bands (although there would still be no direct link to incomes). Any attempt to scrap bands altogether, and simply charge on the basis of regularly updated individual property values, would be better still – although it would probably increase administration costs.

The potential for such an approach to raise additional revenues would depend on the level at which the levy was set. Again, this could be determined locally by councils, with some form of upper limit being imposed by central government. The IFS has estimated that an annual tax rate of around 0.6 per cent would raise funds sufficient to cover current council tax revenues.[80]

The effect on low earners is unclear. It would be preferable to the current council tax structure, which falls most heavily on the group, but it would potentially increase the bills faced by those low earners living in more valuable properties. Transitional issues regarding big increases in charges for some residents would need to be considered more generally, but it is unlikely that low earners would end up disproportionately affected by the replacement of council tax in this way.

---

[79] HMT, *Budget 2010*, Table C6
[80] IFS, *Taxation of Wealth and Wealth Transfers*, p73

Introducing ad-valorem tax on properties over a certain threshold

A similar but more targeted approach would be to raise revenue by imposing a flat-rate levy on properties over a certain value. This revenue could be used by the national Government to close the deficit directly, or it could be raised by local authorities as a means of supplementing council tax receipts (allowing the Government to reduce the value of its grants and close the deficit by another route). In the first instance a single levy would be adopted; in the second, the size of the levy could be decided upon by the local authority. Wilkes has estimated that an average council levy of 0.5 per cent on the value of properties above £500,000 would raise £3-£4 billion a year.[81]

The proposed Liberal Democrat 'mansion tax' represented a move in this direction. Under their proposals, those owners affected would pay a charge only on the value of the property above the threshold. They estimated that a 0.5 per cent levy on properties worth more than £1 million would affect around 250,000 households and raise around £1.1 billion, while a 1 per cent levy on properties worth more than £2 million would affect around 70,000 households and raise £1.7 billion a year.[82]

If the two charges were instead applied to the full value of the relevant properties, they would raise an additional £1.25 billion in the first instance and an additional £1.4 billion in the second (assuming the estimates of numbers of houses above the two thresholds are correct).

Very few, if any, low earners would be affected by the introduction of a charge on the most expensive properties. Some low earners – particularly older members of the group – may live in relatively expensive properties however. Therefore, depending on where exactly the threshold of such a tax was placed, and how the threshold was subsequently adjusted (or not) each year for growth in house prices, significant numbers of low earners could become liable. Some form of rebate could help to reduce the impact, as might the option to defer payment until the property is sold or the owner dies.

Increasing rate of capital gains tax

Capital gains tax (CGT) is imposed on the gain or profit made when a good, such as shares or property, is sold or disposed of. The rate is currently set at 18 per cent, and applies to gains over £10,100 for individuals and £5,050 for trustees. No charge is placed on gains made on primary residences, and entrepreneur's relief

[81] Giles Wilkes, Centre Forum, *A balancing act: fair solutions to a modern debt crisis*, 2009, p48
[82] Liberal Democrat estimates.

allows the first £1 million of capital gains on certain business assets to be taxed at a reduced rate of 10 per cent.

CGT receipts totalled £7.8 billion in 2008-09, but are estimated to have fallen to £2.5 billion in 2009-10, reflecting significant market downturns.[83] This fall in revenue reduces the potential for using CGT as a means of closing the deficit, although there could be increases in future years. The *Ready Reckoner* estimates that an increase of 1 percentage point would raise just £0.1 billion a year in 2011-12.

The scope for using CGT as a revenue-raising measure is improved by the significant discrepancy between the main rate and higher and additional income tax rates, which suggests that the rate could be increased quite significantly for some individuals. The current discrepancy creates an incentive for those earning more than £43,875 to reclassify some of their income as capital gains. For example, owners of small businesses can forgo a salary in order to increase the value of the business, which they can then sell, making them liable to CGT rather than income tax. Similarly, the discrepancy distorts labour market choices, by incentivising careers – such as property development – in which remuneration can be taken in the form of capital gains.

According to an estimate from the Liberal Democrats, returning to a system in which income tax and CGT rates are aligned for individuals would raise £3.2 billion a year.[84] In reality, revenues would be likely to be smaller because any change would need to come with an increase in exemptions and allowances in order to ensure that investment was not disincentivised. For example, a taper could be introduced that reduced the rate paid depending on the length of time the asset has been held.

The IFS, among others, has also questioned the efficacy of the continued absence of indexation allowances for inflation.[85] The failure to account for inflation means that individuals can pay tax equal to or greater than their real capital gain. However, the reintroduction of indexation allowances would both limit the revenue that this approach would generate and would create a distortion in favour of assets that accrued capital gain rather than earned interest income, because such indexation allowance does not exist in relation to savings.

Given that very few low earners pay income tax at anything above 20 per cent, the alignment of CGT rates with personal income tax rates would have only a small effect on members of the group. Instead, the majority of the additional revenue would be sourced from higher earners.

[83] HMT, *Budget 2010*, Table C6
[84] Liberal Democrats Briefing Document, *Liberal Democrat tax plans*
[85] IFS, *Green Budget*, February 2010, p160

Cutting capital gains tax threshold

The *Ready Reckoner* estimates that a cut in the annual exempt amount of £500 for individuals and £250 for trustees would raise just £0.02 billion. This approach is therefore unlikely to prove particularly useful in the efforts to reduce the budget deficit, unless the threshold is cut quite significantly. However, a significant reduction might be the best option in any case. The current presence of a capital gains exempt amount that cannot be offset against the income tax personal allowance produces a distortion in the system, because it benefits those who can divide their annual remuneration into income and capital gains rather than exclusively one or the other.

Again the Liberal Democrats have considered such an approach, estimating that cutting the threshold for individuals to £2,000 would raise £0.9 billion a year.[86]

In this instance, it is likely that some low earners would become liable for CGT, although the number is likely to be relatively small. In addition, the move would still have a bigger effect on those higher earners already liable for CGT because it would increase the value of capital gain that they would be required to pay tax on and, if the above proposal were also introduced, would be charged at their higher rate of income tax.

Charging capital gains tax at death

Capital gains are currently forgiven at death, with the presence of inheritance tax being used as justification. However, this is not a consistent argument because the two taxes are not interchangeable. CGT is designed to ensure capital gains are treated like other forms of income – which are taxed as they accrue. By contrast, inheritance tax is a specific wealth transfer tax and, while imposing both creates 'double taxation', this outcome is implied by the very nature of a transfer tax.

The *Ready Reckoner* estimates that forgiveness of CGT at death cost £0.21 billion in 2009-10. On the basis that most capital gains are enjoyed by higher earners, low earners would not be disproportionately affected by a change in the rules.

Charging capital gains tax on primary residence

A further possible reform to CGT is the removal of the current exemption for gains made on primary residences. The *Ready Reckoner* puts the cost of this exemption at £3.7 billion in 2009-10. In 2008-09, when housing transactions were higher, the cost was £5.0 billion. While the revenue that removal of the exemption might raise would be significantly smaller because of behavioural changes, it would nevertheless be likely to generate substantial annual funds.

---

[86] Liberal Democrats Briefing Document, *Liberal Democrat tax plans*

From the perspective of economic efficiency, there is also an argument for removing the favourable treatment of primary residences. For example, the exemption means that it is currently more attractive for landlords to invest in their own residence (and pay no CGT) than it is to invest in any property that they rent (where CGT would be charged). Increasing CGT as discussed above could make this distortion still worse. Given younger low earners' high level of residency in the private rented sector, removal of the distortion could have important positive implications.

However, the introduction of CGT on primary residences would impose a significant new cost on many low earners. In addition, existing homeowners would probably hold onto their properties longer than they do currently, reducing activity in the housing market and so making it even more difficult for younger low earners to buy their first property. Similarly, home owners wishing to change tenure – in order to relocate for work for instance – are likely to be discouraged. Further problems would arise in instances where homeowners have made consumption decisions based on expected future returns which would subsequently be reduced.

The IFS has suggested one way around some of these problems, which involves providing rollover relief, so that tax on any capital gains reinvested in a new primary residence is deferred.[87] The tax can then be collected when the individual ceases to be a homeowner (usually at death). If however, CGT continues to be forgiven at death, the revenue generated by the exemption removal would be significantly reduced.

Adoption of this approach (with removal of CGT forgiveness at death) would involve some pain for low earners. However, if CGT rates were aligned with income tax rates, members of the group would pay 20 per cent tax on capital gains, while higher and additional rate tax payers would face charges of 40 per cent and 50 per cent. The overall effect of the tax would therefore be progressive, making it a potentially useful contribution to the fiscal consolidation package.

Raising inheritance tax rate

Inheritance tax of 40 per cent is payable on the portion of any estate valued above £325,000, with members of married couples and registered civil partnerships able to transfer unused allowances after one partner dies, such that the threshold can effectively increase to £650,000. Gifts given up to seven years prior to an individual's death are included as part of the total estate value. To the extent that inheritance tax may reduce incentives to work and save, reducing the level of transfers is likely to increase incentives for recipients.

[87] IFS, *Green Budget*, February 2010, p161

Total inheritance tax receipts are relatively small, amounting to £2.8 billion in 2008-09,[88] reflecting the fact that only around 6 per cent of estates are liable for the tax in any year. As such, there appears to be little scope for using increases in the tax rate as a means of significantly tackling the deficit. The *Ready Reckoner* estimates that increasing the tax rate to 41 per cent would raise an additional £0.05 billion a year in 2011-12.

Some low earners are likely to be liable for inheritance tax, so any increase in the tax rate would impact on them. However, the majority of estates falling above the threshold are likely to belong to higher earners, so low earners would not be disproportionately affected.

Reducing inheritance tax threshold

As with increasing the rate, lowering the inheritance tax threshold would raise relatively little. A decrease to £320,000 is estimated to generate £0.03 billion a year in 2011-12. It would probably affect more low earner households than the above proposal, although the majority of estates covered would still belong to higher earners.

Removing inheritance tax exemptions

Agricultural and business properties are currently exempt from calculations of estate value for the purpose of inheritance tax. While some exemption might be appropriate from the perspective of continuity within family businesses, the current blanket exemption appears poorly targeted. For example, reliefs are complete even if the heirs of the deceased subsequently sell the asset immediately after death, while companies which are 51 per cent trading and 49 per cent property investment at death receive full exemption but those for which the figures are reversed receive none.

Any removal or reform of these exemptions would be unlikely to fall disproportionately on low earners, although some might be affected. As with the previous two options, however, the amount of revenue it would raise is relatively small: the *Ready Reckoner* puts the cost of these two exemptions in 2009-10 at £0.35 billion.

Increasing the number of lifetime gifts covered by inheritance tax

As discussed above, any transfers made within seven years of an individual's death are included in the value of the estate when inheritance tax is calculated. Given that those with the most wealth are likely to have a range of investments, they may be able to transfer some assets well in advance of this qualifying period.

[88] HMT, *Budget 2010*, Table C6

By contrast, those with more modest wealth are less likely to adopt such an approach because most of their wealth will be tied up in their main home. Extending the qualifying period beyond seven years is therefore likely to generate extra funds largely from wealthier individuals rather than low earners.

At the extreme, this policy could apply to all lifetime gifts, with inheritance tax then instead being applicable on all gifts given (or perhaps received) above a certain threshold.

By imposing the tax on the recipient rather than the donor, the Government could help to improve wealth distribution by reducing the amount (and associated opportunities) that any single individual receives during their lifetime. Although potentially administratively complex, this proposal could raise significantly more than the current inheritance tax does. It is not possible, however, to estimate the size of potential revenue because no data is recorded on patterns of lifetime gifts outside of the current seven year qualifying period.

Increasing stamp duty land tax rates

Stamp duties are applied to both property transactions (stamp duty land tax, SDLT) and shares and bonds transactions. Taken together, all stamp duties raised £8.0 billion in 2008-09[89] although revenues tend to be relatively volatile, reflecting underlying volatility in property and capital markets.

SDLT is charged on residential and non-residential land and property transactions in the UK and raised £4.8 billion in 2008-09.[90] The tax is charged at different rates and has different thresholds for different types of property and different values of transaction. Prior to the Labour Government's final Budget, SDLT was charged at three different rates in relation to residential properties. Purchase prices of £125,000 to £250,000 were subject to a 1 per cent charge; purchase prices of £250,000 to £500,000 were subject to 3 per cent; and purchase prices above £500,000 were subject to 4 per cent. In each instance, charges applied to the full value of the property, rather than just the part above the relevant threshold.

Based on these rates, the *Ready Reckoner* has estimated that increasing each rate by 1 percentage point would raise £3.18 billion a year in 2011-12, with the increase in the 1 per cent rate raising the most on its own (£1.11 billion). However, this estimate excludes behavioural effects. In reality, the amount raised would be likely to be significantly lower.

Budget 2010 announced that the SDLT threshold for first time buyers would be increased from £125,000 to £250,000 between March 2010 and March 2012, at

[89] HMT, *Budget 2010*, Table C6
[90] HMRC, *Property and stamp duties*, Table T15.4

an expected cost of £550 million over the two years. This reduction in revenue was expected to be more than offset by a permanent increase in the SDLT rate from 4 per cent to 5 per cent for residential purchases above £1 million from April 2011.

Table 2 showed that 71 per cent of low earner households are owner-occupied. However, the majority of these are owned outright, reflecting the high number of older low earners who were able to buy property when price-to-income ratios were significantly lower. Such households are less likely than those who still have outstanding mortgages to move again in their lifetime, and therefore incur SDLT.

Lower levels of housing market activity among low earners are reflected in the fact that just 28 per cent of households in the group have an outstanding mortgage (compared with 54 per cent of higher earners) and by the fact that just 11 per cent of low earner households with a mortgage have moved within the past two years (compared with 18 per cent of higher earner households).[91]

The figures set out above suggest that any move to increase SDLT rates would tend to hurt higher earners most, particularly as higher earners are more likely to buy homes charged at higher rates of tax. However, a significant number of low earners would also be affected, both in terms of facing higher SDLT bills and in terms of the downward pressure that would be applied to prices (for existing homeowners) and market activity (for prospective first time buyers).

In truth, political considerations mean that there is likely to be limited opportunities for increasing SDLT rates at this time, particularly at the lower end of the scale.

Reducing stamp duty land tax thresholds

The *Ready Reckoner* estimates that cutting each of the three thresholds in place before Budget 2010 (£125,000, £250,000 and £500,000) by £5,000, would generate an additional £0.09 billion a year. Again, this estimate takes no account of behavioural changes.

The exemption for residential properties below £125,000 and non-residential properties below £150,000 was thought to cost £0.34 billion in 2009-10. As such, even if the zero-rate threshold was removed altogether, the potential for generating significant funds via altering thresholds appears limited.

The distributional impact of reducing thresholds depends on which are altered. Given that SDLT is already charged on the full value of a property, removing the exempt threshold would have no effect on the tax faced by those buying more

[91] Analysis of CLG, *Survey of English Housing 2005-06*.

expensive properties, meaning that any move in this direction would be likely to disadvantage low earners more than higher earners. By contrast, a reduction in the threshold at which the new 5 per cent rate is payable would fall primarily on higher earners.

Increasing stamp duty rates on shares transactions

Stamp duty is paid on paper transactions for UK shares above a purchase price of £1,000, at a rate of 0.5 per cent. Paperless transactions are charged stamp duty reserve tax (SDRT) instead. Again the rate is 0.5 per cent, but in this instance there is no threshold.

The stamp duties together accounted for around £3.2 billion in 2008-09. As such, reform is likely to offer even less opportunity for raising significant funds than the SDLT reforms discussed above.

Very few low earners own stocks and shares,[92] suggesting that the group would be unlikely to suffer from any attempt to raise funds via this route. However, the potential negative impacts of share transaction stamp duties on the UK economy suggest that there is no real scope for extending this as a revenue-raising mechanism.

For example, stamp duty may discourage shareholders from making investments that increase the value of their shares. That is, firms requiring funds to expand their business may make decisions about proceeding based on a charge that is not related to profits, thus leading to an inefficient allocation of resources.

4.2 Welfare payments

As discussed in Section 3, the new Government has promised that consolidation will be more heavily weighted to spending cuts than tax rises. Chart 16 showed that spending on social protection is expected to account for more than one-quarter of government expenditure in 2010-11, making it hard to ignore when considering the budget deficit.

Clearly, when discussing reducing spending on welfare, low earners could be protected simply by focusing cuts on those benefits which they do not receive. However, while our focus is firmly on the low earner group, we do not believe it is fair or sensible to disproportionately affect benefit-dependent households either. Instead, the purpose of this section is to highlight the effect that some proposed benefit changes might have on low earners, to ensure that they are not overlooked.

[92] Analysis of DWP, *Family Resources Survey*.

With that in mind, it is worth beginning by considering the mechanics of the benefits that low earners are most likely to be in receipt of, as detailed in Table 4: Winter Fuel Payments; the State Pension; Child Benefit; Child Tax Credit; and Working Tax Credit.

4.2.1 Winter Fuel Payments

Winter Fuel Payments (WFPs) are available in 2010/11 to everyone living normally in Great Britain or Northern Ireland who was born on or before 5 July 1950 – that is, the female state pension age – although the qualifying age is set to increase from 60 to 65 between 2010 and 2020. It is paid in a lump sum, and this year is worth £250 for qualifying individuals who are the only eligible people in the home, rising to £400 if they are aged 80 or over. The awards fall to £125 and £200 if the individual lives with another qualifying individual (although the 80+ payment falls only to £275 if the second qualifying individual is not aged 80 or over).

The 2010-11 awards set out above include supplementary payments announced in Budget 2010, meaning that awards in subsequent years should be reduced by £100 for those aged 80 and over and by £50 for those aged between 60 and 80. The scheme cost around £2.7 billion in 2009,[93] with the temporary additional payments expected to cost £0.6 billion in 2010.[94]

4.2.2 State pension

The basic State Pension is paid to individuals as they reach state pension age. It is based on the number of qualifying years the individual has accrued during their working life. A qualifying year is a tax year where an individual has sufficient income to pay National Insurance contributions, is treated as having paid National Insurance contributions, or is credited with enough contributions. In 2010-11, the qualifying annual earnings are £5,044 or more for an employee and £5,075 or more for the self-employed. Men born since April 1945 and women born since April 1950 need 30 such qualifying years to be eligible for the pension.

Those with insufficient qualifying years to receive the full basic State Pension may be eligible for a percentage of the award, and may additionally be able to take action to increase the number of qualifying years they have.

In 2010-11, the full basic State Pension is £97.65 a week and the full basic State Pension for a married woman using her husband's National Insurance record is £58.50 a week. This means that a married couple could get separate basic State Pension payments totalling £156.15 a week. If both partners qualify for a full basic State Pension this could be £195.30 a week. These rates were increased by 2.5 per cent in April 2010, despite RPI inflation being negative in September 2009. The

[93] Environment Food and Rural Affairs Committee, *Energy efficiency and fuel poverty*, HC 37, May 2009, p5
[94] HMT, *Budget 2010*, Table A1

link between annual uplifts and average earnings growth is set to be restored during the current Parliament.

Individuals who have paid into the state earnings-related pension scheme (SERPS) or, since April 2002, the state second pension, should also be eligible for additional State Pension payments, with the value of the payment depending on the size of the contributions made during the individual's working life.

In 2008-09, the Government paid out £62.7 billion in state pensions.[95]

4.2.3 Child Benefit

Child Benefit is a universal award made to families with children who are either: under 16; aged 16-20 and in qualifying education or training; or aged 16 or 17 and not in education or training but registered for work, education or training with an approved body. Benefit is paid at a rate of £20.30 a week for a family's eldest qualifying child and a rate of £13.40 a week for every other child in the family. These rates were increased by 1.5 per cent in 2010-11, despite RPI inflation in September 2009 being -1.5 per cent.

HMRC no longer collects Child Benefit statistics. However, in the last quarter for which data was collected – Q3 2007 – 7.5 million recipients were recorded.[96] Total spending on the benefit amounted to around £11.0 billion in 2008.[97]

4.2.4 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:

- people aged 25 or over without children must do paid work of at least 30 hours a week;
- people with a disability aged 16 or over without children must do paid work of at least 30 hours a week;
- people who are aged 50 or over and are going back to work after being on out-of-work benefits must do paid work of at least 16 hours a week; and
- people with children must do paid work of at least 16 hours a week to qualify.

From April 2011, the qualifying period for those aged 60 and over is also set to be reduced to 16 hours a week.

---

[95] *Guardian Online*, Data Blog: UK Public Spending by Government Department: http://www.guardian.co.uk/news/datablog/2010/may/17/uk-public-spending-departments-money-cuts#

[96] HMRC, *Child Benefit quarterly statistics*, August 2007

[97] ONS, *United Kingdom National Accounts: Blue Book 2009*, Table 5.2.4S

WTC payments include a number of elements to reflect different individual circumstances. These include:

- **basic element** – paid to all who are eligible (£1,890 annual award in 2010-11);
- **couples element** – paid on top of the basic element if a joint claim is made (£1,920);
- **lone parent element** – paid on top of the basic element to those bringing up a child(ren) on their own (£1,890);
- **30-hour element** – an extra payment for those working at least 30 hours a week and to those in a couple, with at least one child, who work at least 30 hours between them (£790);
- **disability element** – an extra payment for those who work and have a disability (£2,570);
- **severe disability element** – an extra payment on top of disability element for those who work and have a severe disability (£1,095);
- **50+ return to work payment (16-29 hours)** – an extra payment made for those meeting the criteria set out above who work for at least 16 hours a week, but fewer than 30 (£1,320);
- **50+ return to work payment (30+ hours)** – an extra payment made for those meeting the criteria set out above who work for at least 30 hours a week (£1,965); and
- **childcare element** – an extra payment up to 80 per cent of eligible costs for those who pay for registered or approved childcare (£175 per week maximum entitlement for first child and £300 per week for two or more eligible children).

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 of elements designed to acknowledge the circumstances of different families:

- **family element** – paid to all who are eligible (around nine out of ten families with children) (£545 annual award in 2010-11);
- **family element, baby addition** – additional family element paid for children aged under one (£545);

- **child element** – paid on top of the family element and baby addition for each child within the family (£2,300);
- **disability element** – an extra payment for each disabled child in the family (£2,715); and
- **severe disability element** – an extra payment on top of the disability element for each severely disabled child in the family (£1,095).

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.

For example, a 30-year old couple with a six year old child who between them work 40 hours a week and earn £24,000 would be eligible for the basic, couple and 30-hour elements of WTC and the family and child elements of CTC. In total, this produces an annual award of £7,495. However, because their income is above the threshold of £6,420, the value would be tapered at a rate of 39 per cent. This means their award would be reduced by £6,856 ((£24,000-£6,420)x39%), leaving them with £589 a year.

As with Child Benefit, all tax credit elements with the exception of the childcare elements of the WTC and the family element of the CTC, were increased by 1.5 per cent in April 2010, rather than being reduced or frozen to reflect negative RPI inflation.

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.

In 2007-08, after adjusting for under- and overpayments, nearly six million families received some form of tax credit. The total comprised 1.4 million out-of-work families and 4.6 million in-work families. Among in-work families, 1.7 million received WTC and CTC, 2.6 million received CTC only and 0.3 million received WTC only. Between them, these families received a total of £21.6 billion in credits.[98]

[98] HMRC, *Child and Working Tax Credits Statistics Finalised annual awards 2007-08*, Tables 1.1 & 2.1

Chart 17 presents a snapshot of the income distribution of in-work family recipients in April 2010.

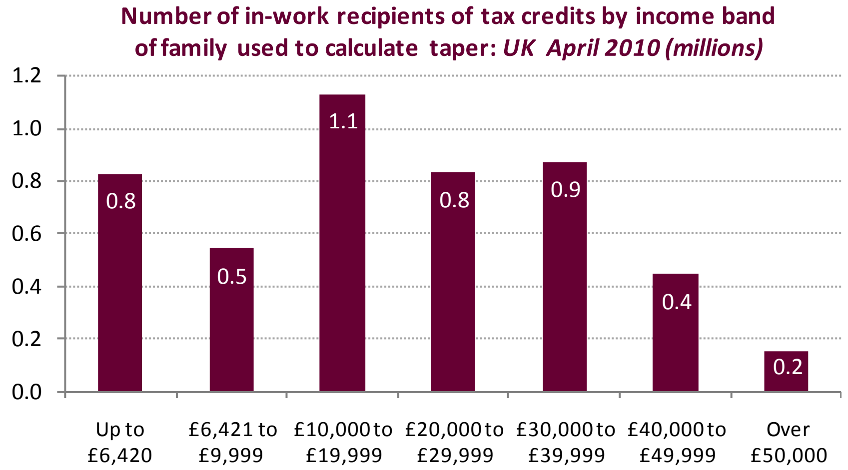


Chart 17: Income distribution of in-work tax credit recipient families: UK April 2010

Note: Income bands are based on previous year's income and some in-year reporting.
Source: HMRC, *Child and Working Tax Credits Statistics: provisional annual awards April 2010,* Section 6

4.2.5 Cutting the welfare bill

There are three broad options for reducing net expenditure on welfare:

- the value of benefits can be cut;
- eligibility rules (income and non-income) can be tightened to reduce the number of people in receipt of benefits; and
- benefit receipts can be taxed.

Generally speaking, the first of these options is likely to be regressive, with the poorest members of society experiencing the biggest proportional drops in incomes. The second option has the potential to be progressive, but it carries particular dangers for low earners, because it implies that the most vulnerable will continue to receive assistance, while those on the cusp of eligibility will find themselves increasingly excluded from state support. The third option is likely to be the most progressive, because it cuts receipts among higher rate tax payers by more than those further down the income distribution.

As before, the low earner impact assessment that follows considers the extent to which the group is disproportionately affected by individual policy proposals, but the most important consideration remains the balance contained in the final consolidation package.

Cutting all benefits values

Cutting the value of a range of income-related and universal benefits has the advantage of being both simple and broad-based. Given that several benefits were uprated in April 2010 despite RPI inflation being negative in September 2009, there may also be an argument on the grounds of fairness in favour of cutting the same benefits in real terms in April 2011.

The Labour Government gave notice of this in PBR 2009 by saying that those benefits uprated by 1.5 per cent in April 2010 would be increased by RPI less 1.5 percentage points in April 2011. However, given that the values of these benefits are currently 3 per cent higher than they would have been if the nominal values had been in line with RPI inflation, the proposed below-inflation growth would still leave the real values higher by 1.5 per cent on a permanent basis. The IFS has estimated that increasing the relevant benefits by RPI less 3 percentage points in April 2011 would save around £0.7 billion a year.[99]

The IFS has further estimated that freezing all benefits in cash terms in April 2011 would save £4.1 billion a year, and that freezing them for the lifetime of the current Parliament could save £24.6 billion a year by 2014-15.[100]

Obviously, any policy of cuts would have the greatest impact on the recipients of the relevant benefits, meaning that it would fall disproportionately on those at the lower end of the income distribution. As such, the gap between rich and poor would grow, particularly if rates were cut in real terms for a sustained period. Low earners would be less affected than members of the benefit-dependent group, but they would share more of the burden than higher earner households.

Cutting universal benefits values ●●

If cuts in benefit values were instead restricted to universal benefits, households across the income distribution would suffer the same cash losses. In proportional terms, the impact would still be felt most acutely in the lower part of the income distribution. However, some of the savings generated could be used to compensate the poorest households. In this instance, the danger is that low earners would fail to qualify for compensation and therefore end up disproportionately affected. In addition, the potential savings would be significantly lower than those associated with cutting all benefits.

For example, there is an argument that the permanent value of WFPs should be cut – or even removed altogether – given that the additional money this represents for pensioner households could simply be provided via the basic State Pension and Pension Credit. Scrapping WFPs altogether would save the £2.1

---

[99] IFS, *Green Budget*, February 2010, p165
[100] Ibid, p166

billion annual cost described above,[101] while reducing the level of awards would save a portion of this. The IFS has estimated that the cost of fully compensating low-income pensioner households for removing WFPs via the Pension Credit would be around half of the total cost of the scheme, meaning that the policy could still generate a saving of around £1 billion a year.[102] Given the low level of Pension Credit receipt among low earner pensioners, the group would be unlikely to benefit from any compensation and would therefore face the largest proportional impact.

A similar outcome could be envisaged in relation to the State Pension. The Labour Government uprated the basic State Pension by the higher of RPI inflation or 2.5 per cent each year, meaning that benefits for pensioners have tended to grow more rapidly than working-age benefits. There is little economic rationale for this. Instead, it is likely to reflect the criticism government receives for small cash-terms increases in pensions during periods of low inflation.

Any move to correct this historical imbalance would require significant real-terms cuts in pension awards and is likely to be politically impossible. A more modest decision to freeze the value of the basic State Pension in April 2011 while increasing other benefits by RPI less 1.5 percentage points might be possible. On the assumption that RPI inflation in September 2010 is 3 per cent, freezing the basic State Pension in April 2011 would save around £1.6 billion a year from that point onwards. Once again, increasing Pension Credit for the poorest households would reduce the overall level of saving while leaving low earners disproportionately affected by the cuts.

Alternatively, the Government could continue to uprate the basic State Pension in line with RPI inflation, but choose to delay restoring the link with earnings, thereby saving an estimated £0.7 billion a year for every year of delay.[103] Given that the Pension Credit guarantee is already uprated in line with earnings, the biggest losers from a delay in restoring the link for the basic State Pension would be non-Pension Credit recipients in the lower parts of the income distribution – that is, low earners.

This approach would also have potentially significant negative consequences for younger low earners enrolling in personal accounts. If the basic State Pension fails to hold its value over time, future recipients are likely to be eligible for means-tested top-ups. Those saving in personal accounts may find themselves ineligible for these because of the extra income provided by their pension, and yet their total income may be no higher than those receiving the top-ups. If, however, the

[101] £2.7 billion annual cost in 2009-10 minus the £0.6 billion cost of the temporary additional payment.
[102] IFS, *Green Budget*, February 2010, p171
[103] Ibid, p175

basic State Pension was to hold its value in real terms, fewer recipients would be considered for means-testing, with or without personal account ownership. Those who had taken out personal accounts would therefore be likely to be better off than those who had not.

A final example in this area relates to the new Government's commitment to ending Child Trust Fund (CTF) payments from January 2011, in order to save £0.52 billion a year. At present, all children have £250 paid by the Government into a CTF at birth and at age seven. An additional £250 is paid for seven years olds living in families in receipt of certain benefits or with incomes below £16,040. The abolishment of all government contributions will have a bigger proportional impact on those in the lower part of the income distribution, particularly those who would have been eligible for the additional payment at age seven. However, in the case of CTFs, it is worth noting that any attempt to restrict access would have risked undermining the business model for CTF providers and so resulted in deteriorating product standards. Therefore a full removal, with reinvestment of the money elsewhere, may be preferable to partial withdrawal.

Cutting tax credits values

According to the *Ready Reckoner*, cutting the values of each of the WTC basic element, 30-hour, lone parent and couple elements by £100 would save £0.9 billion a year in 2011-12. Similarly, cutting both the CTC family and child elements by £100 would save £1.34 billion a year. Clearly, such an approach would disproportionately affect those who currently benefit most from tax credits – low earners. It would also reduce incentives to work for many families (although it would reduce marginal tax rates for those facing withdrawal of tax credits).

Although the majority of tax credit elements were increased above-inflation in April 2010, the value of the CTC family element has been unchanged since 2003, meaning that it has already fallen in real terms by around £130 since its introduction.

Means-testing universal benefits

Given that the same cash reduction in universal benefits has a bigger proportional impact lower down the income distribution, a potentially more progressive means of cutting expenditure is to introduce means-testing in order to restrict access among better-off households while protecting the most vulnerable. The difficulty of this approach for low earners is, as with the options discussed above for compensating the poorest households in the event of benefit cuts, the group may be on the cusp of receiving protection and therefore end up containing the biggest losers. Ultimately the outcome will depend on how the means-tests are designed.

For example, it has been argued that better-off families should not receive Child Benefit because it represents a transfer from those without children to those with, irrespective of the incomes of contributors and recipients. One method of means-testing Child Benefit would be to combine it with CTC and then make it subject to the same withdrawals. The IFS estimates that such a policy would save £5.1 billion a year.[104] The burden would fall primarily on those families with incomes in excess of £24,400, with this threshold increasing by around £6,080 with each additional child. This would mean that some low earners would be affected, but many would be protected, and the biggest losers would be drawn from the higher earner group.

If the policy were designed differently, with Child Benefit removed from all families not in receipt of income support, for instance, low earners could instead be significantly worse off.

There are two additional problems with restricting access to benefits in this way. First, means-tested benefits typically have much lower take-up than universal ones, particularly among older people. Secondly, targeting of policies produces higher marginal tax rates for some and therefore increases disincentives for working and saving. Low earners may be particularly vulnerable to both these effects, given that they are already at the cliff-edge of eligibility and may move in and out qualification for support over the course of the year.

It can be argued that universalism also helps to bind society together, preventing resentment among higher earners about paying taxes without any tangible return. Eroding this principle may make it more difficult to make the case for maintaining certain payments as further spending cuts are sought.

Means-testing tax credits more aggressively

Tax credits are already means-tested to restrict access to those with higher incomes. However, several commentators have argued that the existing thresholds are set too high – Table 5 showed that 14 per cent of higher earner benefit units receive tax credits worth a weekly average of £34.42 for example – meaning that the policy helps families who do not need support.

There are two ways in which better-off families could be removed from tax credit eligibility: by lowering the thresholds at which the credits are tapered and by increasing the taper rates.

According to the *Ready Reckoner*, cutting both the first (£6,420) and second (£50,000) income thresholds for tax credits by £100 would save a total of £0.1

---

[104] Ibid, p171

billion a year in 2011-12, with the reduction in the first income threshold having a much larger effect than the cut in the second.

The IFS has estimated that aligning the first threshold with the currently higher income tax personal allowance would *cost* £0.1 billion a year, but that aligning both at the currently lower National Insurance employer threshold would save £0.6 billion a year in 2011-12.[105] The IFS further estimates that a bigger cut in the threshold to a value corresponding to 16 hours of work a week at the national minimum wage would save around £1.2 billion a year.[106] These approaches would reduce the credits received by all of those on the current main taper – roughly those families with incomes between £6,420 and £24,400 (and some higher income families with more than one child) – and by those with incomes just below the first threshold. The burden would therefore fall primarily on low earners.

Reducing the second threshold would affect fewer people (and be less heavily focused on low earners), but also save less money. Prior to the election, the IFS estimated that a reduction in the threshold from £50,000 to £40,000 would save £0.4 billion a year. However, the Labour Government subsequently argued that the threshold would need to be cut to £31,000 in order to make savings of the order of £0.4 billion, which the IFS accepted to be true.[107] The total saving associated with reducing the second threshold to £40,000 is therefore likely to be somewhat lower.

The second option for restricting access to tax credits is to increase one or other of the tax credit taper rates. The IFS has estimated that (assuming no behavioural response) increasing the main taper in tax credits from 39 per cent to 44 per cent would save £1.3 billion a year, and increasing it to 49 per cent would save £2.3 billion a year.[108] As with the proposal for cutting the level of the first threshold, both of these approaches would affect all of those on the existing tax credit taper – primarily low earners. For those facing withdrawal of tax credits (at a taper rate of 49 per cent) who are paying basic rate income tax (20 per cent) and employee National Insurance (11 per cent), it would also mean that their marginal tax rate would increase to from 70 per cent to 80 per cent, creating a significant disincentive to increase earnings.

The two approaches of cutting thresholds and increasing taper rates could be combined. For example, the family element of CTC could be tapered at a rate of 39 per cent immediately upon the exhaustion of the child element (rather than waiting until the current threshold of £50,000 and then tapering at 6.67 per cent).

[105] Ibid, p167
[106] Ibid, p167
[107] Ibid, p168
[108] Ibid, p167

The IFS has estimated that this proposal would save around £0.9 billion a year.[109] In this instance, the potential losers would be families with children whose household income exceeds £24,400, with this threshold increasing by around £6,080 with each additional child. This would therefore affect some low earner households, but would protect those members of the group with the lowest incomes.

Clearly, identifying the precise losers under each of the various possible scenarios depends on exactly where thresholds are set and by how much tapers are altered. Most of the proposals disadvantage at least some low earners though. In looking to protect the group from tax credit reform, it is not enough to simply set an upper income threshold that exceeds the national median. As discussed in Section 2, we define low earners on an equivalised household basis. That means that household income is adjusted to take account of the size and composition of the household. For example, while a single person household would qualify as a low earner if their income was between £8,250 and £15,750 a year (and less than 20 per cent of the household income was sourced from state support), a household comprised of two adults and three children between the ages of 11 and 18 would qualify with a household income of between £26,350 and £50,300.[110]

Therefore, while there may be some scope for tightening access to tax credits to ensure they are appropriately targeted, it is vital that such an approach is planned carefully, to ensure that losses don't fall heaviest on those they are designed to support most – the low earner group.

Tightening benefit eligibility criteria

Access to benefits can be restricted by tightening a range of (non-income) qualifying criteria such as age, need or duration of circumstance. Potential savings and distributional impacts would vary from scenario to scenario and are not therefore considered here.

However, there is a danger that low earners could once again be most disadvantaged. This is because it is likely that among those excluded from support on the basis of non-income qualifying criteria, those in most financial need would receive assistance via another route (e.g. Pension Credit or Income Support). By contrast, low earners and higher earners finding their access to a benefit barred for non-income reasons would be unlikely to receive any form of compensation. Of course, this position would be harder for the low earner to deal with than for the higher earner.

[109] Ibid, p168
[110] Calculated using McClements Equivalence Scale.

One example is increasing the state pension age. While plans are already in place for increasing the ages at which individuals can receive the State Pension, it has been suggested that an acceleration of this policy would produce significant savings because of the reduction in pension payments and the potential increase in revenues generated by people working for longer. The IFS has estimated that an immediate increase of one year in the state pension age for men and women would reduce spending on the basic state pension by around £2.7 billion.[111] However, the savings would be eroded somewhat by the need to continue paying other forms of means-tested benefits such as Income Support. The IFS estimates that such considerations would reduce the figure to around £2.2 billion.

Despite not being related to income, the decision to tighten eligibility on the basis of age would be likely to have different effects across the income distribution. Table 15 shows that just 18 per cent of men aged 60-64 and women aged 55-59 in the benefit-dependent group were in employment or self-employed in 2007-08, compared with 54 per cent of low earners and 77 per cent of higher earners. The relatively low levels of employment among pre-retirement adults from benefit-dependent households means that they are less likely to notice the difference between retiring at 60/65 and 61/66 than low earners and higher earners are.

Table 15: Economic activity among individuals within five years of state pension age by income group of household: *UK 2007-08*

	Benefit-dependent	Low earners	Higher earners
Economically active	22%	55%	78%
Full-time employee	3%	26%	51%
Part-time employee	8%	18%	18%
Full-time self-employed	4%	7%	6%
Part-time self-employed	3%	3%	3%
Unemployed	3%	1%	0%
Economically inactive	78%	45%	22%
Student	0%	0%	0%
Looking after family/home	3%	3%	2%
Permanently sick/disabled	45%	17%	5%
Temporarily sick/disabled	2%	1%	0%
Other	11%	4%	3%
Retired	18%	20%	12%

Note: Includes women aged 55-59 and men aged 60-64.

Source: Analysis of DWP, *Family Resources Survey 2007-08*

At the same time as being more affected than members of benefit-dependent households, low earners may also be more disadvantaged than higher earners. This is because, despite lower overall employment rates within the group in the pre-retirement age band, the discussion in Section2 highlighted that those low

[111] IFS, *Green Budget*, February 2010, p176

earners who are in work are less likely than higher earners to be in 'good' jobs, meaning that an additional year's work is likely to be less appealing.

Taxing universal benefits

Taxing universal benefits as income can have a similar effect to means-testing, by reducing the value of those benefits to higher earners while protecting – or even boosting – the receipts of the poorest. The big advantage is that it helps avoid the problems of reduced take-up discussed above. The disadvantage is that it would probably save less money because higher earners would still be eligible for 60 per cent (or 50 per cent for additional rate payers) of the value of the relevant benefits.

In addition, from the perspective of low earners, a familiar difficulty remains; namely that their experience will depend on exactly how the taxes are designed. Once again they risk being on the cusp of support if their needs are not recognised. A couple of examples highlight some of the potential issues.

The Environment, Food and Rural Affairs Select Committee has recommended taxing WFPs for basic rate tax payers at the same time as ending entitlement altogether for higher rate payers, claiming that this would save £0.25 billion a year.[112] This would reduce the value of the payments for many low earners, but would ensure that the poorest members of the group – those not paying any tax – would have their positions protected. It would also remove the current anomaly whereby the universal basic State Pension is taxed, but universal WFPs are not. The IFS has estimated that taxing all WFPs (without removing entitlement for higher earners) would save around £0.2 billion a year.[113]

While either of the approaches set out above would place the biggest burden on higher earners, the lack of a taper means that all basic rate tax payers would lose the same cash amount, making the approach regressive within the basic rate band.

In relation to Child Benefit, the ippr has considered a scenario in which the payment is counted as income and taxed based on the rate paid by the highest earner in the family.[114] It suggests increasing the benefit to £22 a week to prevent those with the lowest incomes being worse off, and also suggests ending the difference between the rates paid for the first child and for subsequent

[112] Environment Food and Rural Affairs Committee, *Energy efficiency and fuel poverty*, HC 37, May 2009
[113] IFS, *Green Budget*, February 2010, p172
[114] Because Child Benefit is paid to mothers, failure to take account of the tax rate paid by other members of the household risks disadvantaging working women.

children.[115]The ippr's analysis suggests that this approach would mean that all families with no one paying income tax would be better off, while all families with someone paying higher rate tax would be worse off. Among those families with someone paying basic rate, where the majority of low earner families are, those with multiple children would be better off, but those with just one child would be worse off.

Clearly, the details could be configured differently, to provide protection for all basic rate payers, and the ippr has suggested for instance that further resources could be made available by removing eligibility to Child Benefit for children aged 16 or over in higher income families. However, the ippr acknowledges that this policy in isolation would *increase* the cost of Child Benefit by around £0.8 billion.

According to the *Ready Reckoner*, taxing Child Benefit without changing the existing rates would raise around £1.2 billion a year. Introducing a cost-cutting reform that used some of these savings to increase awards for the most vulnerable would potentially put yet more pressure on low earners without raising much revenue.

4.3 Public services

While cuts to welfare spending are likely to prove important, Chart 16 highlights that nearly three-quarters of total government spending is in other areas. It is likely, therefore, that public services will bear the brunt of fiscal consolidation.

As discussed in Section 1, the new coalition Government has set out plans for £6.2 billion of spending cuts in the current financial year, although specific details are still to be finalised by departments. Going forward, the Spending Review due in the autumn will provide a clearer picture of the budget realities that departments will need to work with over the coming years, and should therefore set a context for debate about what services to cut.

In this section, we consider the consequences of spending cuts for low earners from two perspectives: as consumers of public services (Section 4.3.1) and as public sector workers (Section 4.3.2).

4.3.1 Public services consumption

The magnitude of expected cuts in public services has potentially significant implications for low earners. As Chart 13 showed, those in the lower half of the income distribution derive substantially greater benefit from spending on public services than those in the top half. Our analysis of the ONS figures on tax and benefits shows that, within the low earner group, the value of benefits in kind

[115] Kayte Lawton and Kate Stanley, "Welfare spending – Time to reassess universal benefits?", in ippr, *Opportunities in an Age of Austerity: Smart ways of dealing with the UK's fiscal deficit*, November 2009

associated with consumption of health and education services represented 31 per cent of final income in 2007-08. The corresponding figure in the higher earner group was just 13 per cent.[116]

Chart 13 suggests that the effect is not as marked in relation to other forms of public spending. For example, while the value of spending on ‘other’ benefits (including defence, public order and safety, recreation, culture and religion) is estimated to have been worth an average of £5,500 to households in the lower half of the income distribution in 2006-07, the value for those in the top half is estimated to have been £5,700, suggesting that higher earners derive greater benefit from such services.

We have already seen that this analysis is based on assumptions that the ONS would not consider “reasonable”. If, however, it is assumed to be indicative of reality at least, then it suggests that cuts to health and education services would do proportionally more damage to the low earner group than cuts in other areas. In truth though, what matters is not which departmental budgets are cut and which are protected, but how departments respond to straitened financial circumstances.

Reform and efficiencies

As we concluded in Section 3, a package for fiscal consolidation needs to stem from a zero-based review of the function of government. Such a review should identify three means of cutting public service expenditure:

- making efficiency savings;
- reforming service delivery and transferring resources between services to achieve better outcomes; and
- identifying priorities and ending activity in non-priority areas.

From the perspective of consumption, the achievement of genuine efficiencies should have no distributional impact. That is, service standards will remain unchanged or improve, despite a cut in inputs.

Similarly, reform of public service delivery can produce savings while at the same time improving outcomes. For example, resources can be transferred from services that pick up the pieces to more efficient investment in prevention and early-intervention. Alternatively, programmes such as Total Place, which identify duplication of services and produce a more joined-up approach to delivery, can both reduce costs and improve user experiences. Such approaches should not compromise – and may improve – the position of low earners as consumers of public services.

---

[116] Analysis of ONS, *The effects of taxes and benefits on household income*, Table 14.

While much depends on how successfully the Government can deliver such savings, for the purposes of this report we take it as given that the Government and service providers are aware of the potential benefits and will achieve all appropriate efficiencies and reforms. We do not include any analysis of such measures because of the lack of distributional consequences.

Programme cuts

Instead, this section considers the ways in which low earners might be affected by absolute cuts in government programmes – from the generic to the specific. As with the previous sections, the policy proposals we consider are not limited to those we might expect to see in the forthcoming Budget, nor are they exhaustive. There are, for example, a number of programmes which the new Government may choose to cut for which it is very difficult to claim any distributional bias. Cuts to the ID Card Scheme, ContactPoint, the NHS IT Scheme, the National Identity register, police numbers and defence projects and equipment may or may not be desirable, but they are unlikely to disproportionately affect low earners.

The proposals we have chosen to comment on represent a list of those suggestions that we have seen discussed by a range of commentators that we feel could have specific implications for low earners.

Letting NHS waiting lists grow

While the new Government has pledged to increase NHS funding in real terms in each of the next five years, demand may still outstrip funding because of the ageing population and expected increases in chronic and 'lifestyle' conditions such as heart disease and obesity. There is also the danger that cuts in funding in other areas, such as social care, will put more strain on health resources. In addition, prices in health – for new drugs and technologies for example – tend to grow more quickly than economy-wide prices, meaning that 'real-terms' increases may not keep pace with actual cost pressures.

Therefore, despite its apparent protection, the NHS is likely to need to make savings in order to stand still: the King's Fund and IFS have suggested that, based on a scenario of zero real-terms growth in funding, £19 billion savings (2011-12 prices) over the three years from 2011 will be required.[117] While a variety of reforms and efficiencies are likely to be pursued, the option remains to allow service standards to slide, by letting waiting lists grow for example. Such an outcome is unlikely to be a political ambition, but it could become a reality if costs pressures become severe enough.

[117] The King's Fund and IFS, *How cold will it be? Prospects for NHS funding 2011-2017*, July 2009

It would be likely, however, to prove a false economy. While treatment of fewer patients might produce savings in one year, these could only aid closing the structural deficit if patient numbers were permanently lowered, suggesting that waiting lists would need to grow year after year. Moreover, delays in treatments would mean that the conditions of patients seen by the NHS would be more advanced, and therefore more difficult to deal with. In addition, managing long waiting lists would produce additional costs.

From a distributional perspective, such an approach would be likely to fall most heavily on those at the lower end of the income distribution, with higher earners having the option of paying for private care. It could also be argued that low earners might be even more disadvantaged than members of benefit-dependent households, because of the impact prolonged periods of ill-health would have on their ability to remain at work.

Increasing user-charging in the NHS

The NHS already charges for a number of services in England, including prescriptions and dental treatment. Exemptions based on age, income and condition mean that around half of the population are exempt from prescription charges and around one-quarter are exempt from dental charges. Many low earners do not qualify for assistance, while people on high incomes who meet age and condition criteria do: in 2007, 64 per cent of the prescription items dispensed in the community were exempt from charge on the basis of age, 7 per cent were exempt on the basis of condition and 10 per cent on the basis of income-related benefit receipt. The NHS Low Income Scheme provides some help for people not exempt from charges on the basis of income-related benefit receipt, but the capital threshold is low and the application process is lengthy and complicated: just 1 per cent of dispensed items were free on this basis in 2007.[118] The House of Commons Health Select Committee stated in 2006 that: "Those most affected by charges are working adults on incomes just above the level of Income Support".[119]

According to figures from Citizens Advice, 0.8 million people in England and Scotland failed to collect a prescription in 2007 because of the cost involved.[120] Citizens Advice also found that around 7.4 million people did not visit an NHS dentist in the 19 months from April 2006 due to difficulties finding one. Of these, around 4.7 million attended a private dentist instead and 2.7 million received no

[118] NHS Information Centre, *Prescriptions Dispensed in the Community*, 31 July 2008, Table 4

[119] Health Select Committee, *NHS Charges*, 18 July 2006

[120] Citizens Advice press release, "Prescription costs are barrier to health says Citizens Advice", 27 February 2008

treatment.[121] Any increase in existing user-charges is likely to continue to fall most heavily on low earners and reduce their health outcomes still further.

The argument for introducing a charge for GP appointments is that it would both raise revenues and help to ration demand. However, it would risk further damaging health prospects in the low earner group. Clearly a flat-rate charge for all GP visits would be regressive: not only would each visit cost more as a proportion of income for those at the lower end of the income distribution, but such individuals are also likely to make more visits because ill-health is more prevalent at lower incomes. However, any attempt to provide exemption for certain people on the basis of income and/or condition would penalise low earners if the exemption threshold was set too low, and would raise relatively little revenue if it was set too high.

From a practical perspective, GP charges may produce other problems. The revenue raised will be eroded somewhat by administration costs and, more importantly, charging for primary care services could push demand into more expensive remedial areas such as A&E.

Scaling back free nursery care ●●

All three and four year olds in England are entitled to 12.5 hours of free early education a week at nurseries, playgroups, preschools or childminders for 38 weeks of the year. In January 2009, nearly 1.2 million children benefitted from at least some free provision, representing 92 per cent of all three year olds and 98 per cent of all four year olds.[122] The entitlement rises to 15 hours a week in some local authorities, and will be at this level in all areas from September 2010. PBR 2009 also stated that two year olds from low or modest income families would be entitled to ten hours of free care by 2015, with rollout beginning in April 2011.[123]

The new coalition Government has confirmed its commitment to free nursery care and argued that support should be supplied by a diverse range of providers. However, a number of private, voluntary and independent providers have argued that the rates paid per place by local authorities do not cover the true cost of provision.[124] The danger exists that, faced with calls to increase funding in order to sustain provision, the generosity of the offer is instead scaled back. This could include ending universalism or delaying the extension to two year olds for instance.

---

[121] Citizens Advice press release, "Millions have difficulties accessing an NHS Dentist ", 16 January 2008
[122] DCSF, *Provision for Children Under Five Years of Age*, June 2009
[123] HMT, *PBR 2009*, December 2009
[124] See for example, NDNA, *The Free Entitlement and the Real Cost of Childcare in Day Nurseries*, September 2006.

Any move away from a universal offer risks putting low earners once again at the cliff edge of entitlement. Provision linked to the receipt of certain benefits would exclude most low earners from accessing support. While higher earners might be expected to be able to afford alternative provision in this circumstance, low earners who already live at the edge of their means are likely to find it much harder to deal with.

Similarly, low earners might be more likely than members of either higher earner or benefit-dependent households to derive benefit from any extension of provision – and therefore be more disadvantaged by delays in this timetable. This is because low earners are more likely than those in benefit-dependent households to have work commitments, while at the same time being less likely than higher earners to be able to work flexibly around childcare needs.

Cutting Sure Start funding ●●

Sure Start children's centres provide a variety of advice and support for parents and carers, from pregnancy until the child goes into reception class at primary school. All centres provide a core set of services, including child and family health services and help for parents to find work or training, and most provide childcare. Some centres offer additional services such as access to a dentist or physiotherapist. Many of the services are free, while a few are charged for.

The aim of Sure Start is to extend equality of opportunity by improving child development and supporting parents. While access to the services is universal, provision has been targeted at deprived areas. Evaluation of the programme suggests that it has been largely successful (with benefits associated with seven out of 14 assessed outcomes),[125] and that usage of services is most prevalent among families with lower incomes.[126]

While the new Government has pledged to protect the Sure Start budget from cuts in the current financial year, there is no similar promise for future years. In addition, the coalition agreement states that the Government will look to increase the focus of Sure Start on the neediest families.

While focusing resources on the most vulnerable may be an appropriate response to fiscal realities, it is another area in which spending cuts could inadvertently fall most heavily on low earners. That is, if provision for benefit-dependent households is protected, while families in higher earner households are already less likely to use Sure Start services – and in any case would find it easier to fund

---

[125] National Evaluation of Sure Start, *The Impact of Sure Start Local Programmes on Three Year Olds and Their Families*, March 2008

[126] DCSF, *Sure Start Children's Centres: Survey of Parents*, 2009, Table 3

private alternatives – the low earner group is most likely to suffer from a restriction of access.

Increasing class sizes

The new Government has pledged to protect schools from the cuts planned for the current financial year, but beyond this timeframe there is no promise in place. As with the option of increasing waiting lists in the NHS, one option for making savings in the education budget would be to increase pupil to teacher ratios by increasing the average class size. Again it is unlikely to be a political ambition, but it could become a reality as funding pressures bite. Cuts in teacher assistant numbers would be particularly likely.

Between 1997 and 2009, teacher numbers in England increased by 11 per cent from 400,000 to 443,000 and the number of teaching assistants tripled from 60,000 to 180,000.[127] Over the same period, the number of pupils fell, meaning that pupil to teacher ratios were substantially reduced. It is possible therefore that there is scope for making some cuts without detriment to service standards, although the lack of evaluation data means that this is difficult to guarantee. As stated above, if genuine efficiencies can be achieved, there should be no distributional impact – the same service standard will be maintained.

If, however, cuts in teacher and teacher assistant numbers are sufficient to reduce the quality of education, then low earner families would be likely to be affected to about the same extent as benefit-dependent families, but by slightly less than higher earner households. This is both because of the latter's access to private education and because evidence suggests smaller class sizes have more of a beneficial effect on pupils from disadvantaged backgrounds.[128]

Capping university places

The weak labour market encouraged a surge in applications for university courses in 2009-10. However, in an attempt to control public expenditure, the Labour Government placed a cap on new places of 10,000, fining universities for every student recruited above the limit. As such, demand significantly outstripped supply and many prospective students were unable to secure places. Those affected were most likely to have lower A-level results and to come from 'non-traditional' backgrounds (because they tend to apply later in the process than students from sixth form colleges), suggesting that the cap falls more heavily on lower-income households than on higher earners.

---

[127] DCSF, *School Workforce in England (including Local Authority level figures*), January 2009 (Revised), Table 1

[128] Peter Blatchford, "Class Size", in Eric Anderman (ed.), *Psychology of Classroom Learning: An Encyclopedia*, 2009

Budget 2010 announced a £270 million university Modernisation Fund, designed in part to provide an additional 20,000 student places in 2010-11, but only in science and technology subjects. Moreover, the new Government has since halved this fund, thereby reducing additional numbers to 10,000. The effect is that students from lower-income households are again likely to be disproportionately affected by insufficient supply this year. Any continuation of a capping policy will have similar effects, suggesting that an alternative solution is required.

Cutting generosity of maintenance grants

English higher education institutions can charge students up to a cap of £3,225 a year in 2009/10 (rising to £3,290 in 2010/11) for their full-time undergraduate courses. To help with the cost of these tuition fees, students can apply for a maintenance grant up to a value of £2,906. Entitlement is means-tested: a full award is available for students living in households with incomes of £25,000 or less, and partial awards are available for those in households with incomes up to £50,200. In total, around 40 per cent of students qualify for a full grant and two-thirds receive some form of grant. This is a higher proportion than the Government anticipated when it reintroduced grants in 2006, and therefore represents a significant increase in costs. Moreover, any increase in the tuition fee cap feeds through to higher maintenance grants and therefore an increased bill for the state.

One means of reducing the cost of these grants is to tighten eligibility. Given that the current threshold for a full award already falls within the range of low earner household incomes, the danger for low earners is that they fall the wrong side of any revised boundary, meaning that some prospective students from low earner households might be discouraged from applying for university.

Charging higher interest on student loans

Students have the option of taking out loans, which they repay after graduation, to both cover their tuition fees (up to £3,290 in 2010/11) and put towards their living costs (up to £4,950). These loans are taken out by more than four-firths of undergraduates and are subsidised by the Government so that interest rates cover inflation only – effectively a zero real rate of interest. Repayments are not required until the graduate is earning above a threshold of £15,000 a year and any outstanding loan is written off after 25 years.

As with maintenance grants, the subsidies provided on these loans represent a significant cost to the Government,[129] and one that will grow with any increase in

[129] £1.2 billion according to Professor Barr: see *Times Higher Education*, "Top earners gain from student loan 'subsidy' as low-paid struggle", 27 March 2008.

the tuition fee cap. In this instance, however, they are also regressive, because they particularly benefit students from higher-income families who gain better qualifications and therefore are more likely to attend institutions charging the highest fees.

The subsidy, and therefore the cost, of providing these loans can be reduced by the introduction of higher rates of interest. One option would be to charge interest at the same rate that the Government can borrow at. This would be likely to have a similar impact to reducing the generosity of maintenance grants, in that it would potentially discourage individuals from low-income (including low earner) households from going to university.

A more progressive option would be to charge higher rates of interest on loans taken out by students from higher earner households, while maintaining the subsidy for those from lower-income households. Clearly this would reduce the value of savings, although the ongoing subsidy to lower income undergraduates could be part covered by increasing interest rates for better-off students above the Government rate. The extra revenue generated could also allow the loan scheme to be expanded to groups – such as part-time students – who don't currently have access, thereby helping to widen participation among lower-income households. Once again the impact on low earners would depend on exactly where the threshold was placed, but it is likely to be a preferable option to increasing repayments for all students.

Cutting spending on skills training

Government spending on skills training is often accused of generating a significant amount of deadweight –that is, it duplicates what business already provides or would be happy to provide: one estimate from the IFS in relation to Employer Training Pilots suggested that 65-100 per cent of spending on the programmes represented deadweight.[130]

In the 2010/11 academic year, the total skills funding budget was set to be £4.5 billion.[131] The coalition Government has since announced that it is scrapping the £101 million Young Person's Guarantee and that it will cut £200 million from the £983 million Train to Gain budget, with funds being recycled into adult apprenticeships and a further education college capital programme. More substantial cuts in the skills budget are likely to follow in subsequent years.

As discussed in Section 2.3.2, low earners often find themselves squeezed in relation to training: too low skilled to be the focus of training by employers and

[130] IFS, *The Impact of the Employer Training Pilots on the Take-up of Training Among Employers and Employees*, 2005
[131] BIS, *Skills Investment Strategy 2010-11*, November 2009, p10

too income- and time-poor to fund their own training, yet too high skilled and too income-rich to qualify for government support. While this suggests that current government spending on skills policies is failing to reach the group – and should therefore be reformed – it also highlights the vulnerability of low earners to reductions in skills budgets: the more that access to funding and support is restricted, the harder it will become for low earners to up-skill and re-skill. This is likely to be particularly important during a period of high unemployment and reduced labour market opportunities.

Reducing long-term care funding

Older people in England assessed by their local authority as needing a care home placement are means-tested to determine who pays. The means test consists of a capital element and an income element. Individuals with qualifying capital above the upper threshold of £23,250 receive no financial support. Those with less than £14,250 capital are assessed on the basis of their income only. Those with capital valued between the two thresholds are assessed on the basis of their income and their "tariff (capital-related) income". The current rate of the Personal Expenses Allowance (PEA) is £22.30 a week; any income, including tariff income, above the PEA goes towards the cost of the care home accommodation.

In 2002, 72 per cent of low earners aged over 60 had wealth greater than the higher capital threshold. Around 71 per cent of these were married or living as a couple and therefore would have their home disregarded from the means test if they needed care. As a result, at least 21 per cent of low earners would be required to self-fund their long-term care needs.[132]

In reality, this proportion is likely to be higher because local authorities only undertake a means test for those individuals assessed as having needs that meet their eligibility criteria, meaning that funding is increasingly restricted to those with the most acute needs. In addition, the proportion with capital in excess of the upper threshold is expected to rise as baby boomer homeowners reach retirement.

Older low earners therefore often find themselves in a difficult position when faced with the means-testing criteria of the long-term care system. They are frequently income-poor and asset-rich – too rich to be eligible for state subsidised care.

Low earners hold more of their wealth in the form of property than members of the high earner and benefit-dependent groups. On average, low earners have three times as much wealth stored in property as they do in liquid assets: among

[132] Resolution Foundation, *Lost: Low earners and the elderly care market*, February 2008, p13

higher earners the ratio is 2:1.[133] As such, low earners needing long term care are more likely to have to access the wealth stored in their homes. Falling prices and inactivity in the housing market are likely to have made this more difficult since 2007, as is the contraction of the equity release market.

These low-income, low-liquid wealth homeowners are therefore faced with a limited number of choices:

- sell their home and downsize, using the remaining capital to purchase domiciliary care;
- sell their home and move into residential care (perhaps prematurely);
- resort to (rather than choose) informal care; or
- go without care.

Any reduction in funding for social care, resulting in a lower means-test threshold or PEA and forcing local authorities to further tighten eligibility requirements, would therefore fall most heavily on low earners.

Cutting transport spending

Transport spending often fares badly in periods of fiscal consolidation, because cancelling infrastructure projects tends to be easier than cutting current expenditure in other areas. A similar approach appears likely in the coming years, with the £643 million cut in the 2010-11 Department for Transport budget being among the largest of those set out by the new Government for this financial year. The savings are set to include a £309 million reduction in grants to local authorities, a £108 million cut in the Transport for London grant and a £100 million reduction in Network Rail's budget. Other savings will be made via direct spending cuts within the department and deferral of lower priority projects, such as highways improvements on the A453, A23 and M6.

Transport spending has an uncertain distributional effect, and the impacts of cuts are likely to depend in part on which projects and services are affected.

Our analysis of the *Family Resources Survey* suggests that public transport costs are highest as a proportion of gross income in the higher earner group and lowest in the low earner group, suggesting that low earners would not be disproportionately affected by cuts in this area. However, the differences are relatively small and represent averages – within each income group some will be more exposed to cuts than others. Moreover, within the broad public transport headings, levels of expenditure vary. For example, higher earners spend much more on rail fares than members of the other two groups, but less on bus fares. This has important implications, because local authority transport grants (and

[133] Ibid, p13

therefore subsidies for concessionary bus fares) are expected to be more vulnerable to cuts than rail travel, because a large proportion of spending in the latter is already contractually committed.[134]

In contrast to public transport, total spending on operation of personal transport – excluding vehicle purchases and including expenditure on transport fuel – is proportionally highest in the low earner group and lowest in the benefit-dependent group, suggesting that low earners spend more time on the road and are therefore most likely to be affected by cuts in maintenance and upgrades. Again, highways spending is believed to be more likely to get cut than rail expenditure.

Cutting bus industry fuel grant

In addition to funds made available to bus operators by local authorities, the Department for Transport pays Bus Service Operators Grants (BSOG) direct to all local bus services in England open to the general public, and to a wide range of community transport providers. BSOG represents a £0.4 billion subsidy[135] and is equivalent to 80 per cent of the fuel duty paid by bus operators on ultra-low sulphur diesel (100 per cent for new, cleaner fuels). This reduces operators' costs, making more services commercially available and helping to keep fares down.

One means of reducing expenditure could therefore involve cutting this grant, with pressure growing in any case because of the environmental implications of subsidy and because of state aid rules. However, this is likely to result in an increase in fares and, as the analysis above shows, spending on bus services is proportionally higher in the benefit-dependent and low earner groups than it is the higher earner group, suggesting that the move would be regressive.

Reducing investment in house building

As discussed in Section 2.2, younger low earners are particularly squeezed in relation to housing: too poor to be able to access home ownership and too rich to qualify for social housing. The most obvious way of improving this situation is to increase the supply of housing, thereby helping to moderate house prices and boosting social provision. Additionally, the group would benefit from more investment in the private rented sector where increasing numbers live.

The first round of cuts announced by the coalition Government produced mixed news for housing. The Homes and Communities Agency (HCA) – the main body responsible for social housing and public sector land – has announced that it will

[134] David Begg, "Transport – How do we identify the priorities?" in ippr, *Opportunities in an Age of Austerity: Smart ways of dealing with the UK's fiscal deficit*, November 2009
[135] DfT, *Annual Report and Resource Accounts 2008-09*, July 2009

be cutting £230 million from its budget in 2010-11, including £100 million from its £2.4 billion social housing programme and £50 million from its £420 million Kicksart programme, which invests in restarting mothballed private housing developments. By contrast, the Government announced that £170 million of savings from other departments would be reinvested in social housing.

If fiscal consolidation leads to housing investment being cut in future years, the burden is likely to fall disproportionately on low earners, with younger members of the group finding it increasingly difficult to access either home ownership or social tenancy.

Cutting low cost home ownership programmes

A range of low cost home ownership (LCHO) programmes are designed to help people with incomes of £60,000 or less to own or part-own property. However, data on the median incomes of those households accessing LCHO properties show that, in most instances, clients have been drawn from those with above national median incomes (i.e. the upper threshold for the low earner group). The only LCHO scheme in which median incomes of clients have been below the national median has been the Right-to-Buy programme.[136]

Cuts in 2010-11 are due to reduce the LCHO budget by £100 million. Any further cut in the level of support offered is likely to move the programmes still further from the reach of low earners, but will primarily affect those higher earners who are currently most likely to be able to take advantage. Therefore, as currently configured, we don't think that cutting LCHO funding would disproportionately affect low earners, although we would like to see reform of this support alongside any funding withdrawal, in order to provide more targeted support for low earners.

Charging for local authority services

The cuts announced by the new Government for 2010-11 include a £1.165 billion reduction in grants to local authorities. Alongside this, the Government is removing ring-fencing around £1.7 billion worth of grants, in order to allow local authorities freedom to identify their own priorities for spending.

Faced with ongoing funding cuts in future years, councils will need to adopt many of the same approaches as national Government in relation to tax rises, efficiencies, pay freezes and staff cuts. As with national Government, such measures will only take part of the strain however, meaning that some services will need cutting.

---

[136] Analysis of CLG, *Who are the Low Cost Home Ownership (LCHO) purchasers and what is the demand for LCHO?* December 2006.

Once more, as at the national level, local authorities should avoid simple salami-slicing and should instead identify priorities which provide a framework for resource distribution. We have looked at some specific service cuts – long-term care for example – elsewhere in this section. Other options include cutting back in areas such as refuse collection and fire services. However, councils have statutory duties in these areas, meaning that it would be easier to cut back on non-statutory activities such as libraries, parks and leisure facilities. Cuts in statutory and, more particularly, non-statutory services would be likely to fall most heavily on those in the lower half of the income distribution, with higher earners better placed to access similar services on a paid-for basis.

Councils could also choose to extend user-charging for a number of services. One option is to adopt an 'Easy Council' model, in which all residents have access to basic services – in relation to social services for example – with the option of paying more to top-up. Discounts and exemptions could be provided for some but, as with all of the other means-testing and co-payment options discussed in this section, low earners who fall on the wrong side of the threshold will be hardest hit.

Another option is to increase charges in areas in which councils already raise revenues, such as parking, licences, planning, leisure facilities and fines. The distributional effects in this instance are more difficult to predict, because some of the charges relate to areas in which income may not be relevant. However, if the volume of charges were spread equally across households then the move would be somewhat regressive, because the imposition of flat cash charges would mean that those in the lower half of the income distribution would pay more as a proportion of their income.

4.3.2 Public sector employment

Above, we acknowledged that efficiencies and public service reform should be positive for low earners from their perspective as consumers. However, efficiencies usually translate into job losses, and this could create difficulties for those low earners working in the public sector. More generally, any cuts in services are likely to involve staff reductions.

Table 9 showed that low earners held around 1.8 million jobs in the industrial sectors of *education, health and public administration* in 2007-08, representing nearly one-quarter of all jobs in these areas. 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.

These figures suggest, therefore, that just short of one-quarter of working low earners are in the public sector. It points to the need to consider how the impact of consolidation on the public sector workforce will particularly affect low earners. However, because three-quarters of the low earner workforce is in the private sector, we must balance these concerns with the need to ensure that the group is not protected at the disproportional expense of the low earner taxpayer.

Cutting public sector pay

One of the reasons employment has not fallen by as much as was forecast in the private sector during the recession is that workers have displayed wage restraint, preferring to accept pay freezes over job losses. A similar approach could be argued for in the public sector.

The public sector pay bill has grown steadily as a share of GDP in recent years, and stood at £160 billion in 2008-09, representing around 23 per cent of all government spending.[137] This increase has in part been caused by increased recruitment, but also in part by salaries that have grown faster on average than in the private sector. Factoring in falling productivity in the public sector relative to the private suggests that wage differentials have grown even more significantly over time.

To some extent, the more rapid rises in public sector pay may be a result of past underinvestment and the need for salaries across the two sectors to be equalised. However, in 2009, the median salary in the public sector was 7 per cent higher than in the private. Among full-time workers the difference grew to 11 per cent, and among women the public sector median was 32 per cent higher.[138]

Analysis by the IFS suggests that such a straight comparison is misleading and that, once pay is adjusted for age, experience and qualifications, the differential between the public and private sectors closes quite significantly.[139] Nonetheless, a gap remains, and it has probably grown during the course of the downturn. Moreover, inclusion of generous public sector pensions in the analysis shows that the overall remuneration package in the public sector is more attractive for the majority. There may, therefore, have been cause for a period of wage restraint in the public sector even in the absence of a fiscal imperative.

However, the analogy with the private experience of avoiding unemployment by reducing salaries is imperfect. That is because, while private sector firms have chosen to hold onto labour at reduced cost during the downturn in the expectation of eventual recovery, the cutbacks being made in the public sector

[137] HMT, *PESA 2010*
[138] ONS, *Annual Survey of Hours and Earnings 2009*, Table 13.7
[139] IFS, *Green Budget*, February 2010, p220

need to be permanent, in order to deal with a structural deficit. The IFS has argued for instance that pay cuts are not a sustainable solution for cutting government spending because of the tendency for subsequent 'catch-up' pay increases.[140]

Such catch-up is only likely to be needed, however, if pay cuts are substantial enough to open a pay differential in the opposite direction. If public sector remuneration packages are held only to the extent that they become equalised with the private, then labour market conditions should instead approach a situation in which incentives for growth and innovation are efficiently distributed across the economy. The analysis does highlight the fact that wage restraint will have its limits, however, meaning that job cuts are also likely to be required.

IFS modelling suggests that freezing public sector wages for two and a half years in recognition of an average 5 per cent pay gap between the public and private sectors and underlying inflation of 2 per cent, would reduce earnings by around £7.5 billion a year. Once lost income tax revenues and increased benefit expenditure is factored in, the IFS estimates that the total saving to government would be around £5.5 billion a year.[141]

The Labour Government confirmed in Budget 2010 that there would be no pay uplift in 2010-11 for senior public sector staff including the senior civil service, the judiciary, consultant doctors, senior managers in the NHS and self-employed GPs and dentists. In addition it reiterated that, excluding those on existing three-year deals, basic pay uplifts in the public sector would be restricted to 1 per cent in 2011-12 and 2012-13.[142] The Government claimed that this would save £3.4 billion a year, but this appears to be a gross figure: the IFS estimates that lost tax revenues and increased welfare spending would produce a net saving closer to £2.1 billion a year.[143]

The approach adopted by the Labour Government – to restrict wage growth for most members of the civil service and freeze it altogether for the highest paid – is one that also appears to be favoured by the new coalition Government. This is a key distinction for low earners. Any cap on pay that is instead expressed in flat rate terms for all staff is likely to disadvantage the group (that is, a 1 per cent pay increase is worth more in cash terms for higher earners than for lower earners – although some low earners will be compensated in part by an increased entitlement to tax credits). By contrast, any attempt to allow modest pay rises below a certain salary threshold while imposing freezes above it would be likely to favour low earners.

[140] Ibid, p220
[141] Ibid, p227
[142] HMT, *Budget 2010*, para 6.22
[143] IFS, *Green Budget*, February 2010, p229

Of course, the precise impact would depend on where the threshold was set. A better option still for low earners may therefore be a flat cash limit on pay awards, which would mean that the pain fell more heavily on higher earners in the sector (that is, a £100 increase in pay would be worth more to lower earners than to higher earners).

Further complication is added by the IFS finding that public-private pay differentials vary by region and by gender. It notes that the adjusted pay gap for women is 7 per cent, compared with just 2 per cent for men. It also suggests that differentials in London and the South East tend to be negative (that is, private sector pay is higher when adjusted for age and qualifications), while in the rest of the UK differentials are higher than the national average of 5 per cent.[144]

We wish to ensure that low earners working in the public sector are not exposed by a public sector recession in the same way as low earners in the private sector have been by the wider downturn. However, we are also keen that wages in the two sectors are equalised so that the 5.4 million low earners who work in the private sector are not disadvantaged relative to workers in the public sector. We therefore recommend that public sector wages are cut relative to growth in private sector salaries, but only to the point at which the estimated pay differential between the two sectors is equalised. We further recommend that this pay adjustment takes account of regional differences in pay differentials, and that it is conducted in a way that provides room for stronger growth in pay among lower paid members of the public sector.

Cutting public sector employment

A number of commentators have highlighted the decline in productivity in the public sector relative to the private sector in the last decade as evidence of the scope for cutting jobs in the former without damaging service standards. Some argue that such cuts should focus on unproductive, non-frontline jobs, but others suggest that any attempt to trim the public sector workforce has to consider frontline staff as well, because they make up such a large proportion of the total. Indeed, the biggest increases in headcount in the last decade have been among frontline staff: the number of teaching assistants rose by 260 per cent between 1997 and 2008, doctor numbers grew by 49 per cent, nurses by 28 per cent and police by 24 per cent.[145]

If cuts are made – in either the frontline or back office – it is important that they reflect a measured assessment of the priorities for government. If they are instead made simply in those areas where it is easiest (or cheapest) to let people

[144] Ibid, Table 9.4
[145] Ibid, p217

go, the danger is that declining standards of public service will create the need for subsequent recruitment drives that once again leave the public sector over-staffed. A sustainable reduction in public sector headcount instead needs to begin with an honest assessment of the future role of the state.

The new coalition Government has avoided the trap of rushing into job cuts (and redundancy payments) by announcing a recruitment freeze in the civil service in the remainder of 2010-11. The freeze applies across government departments, agencies and NDPBs, with exceptions in place for recruitment via the graduate fast stream (which is already underway), "business critical appointments" and key frontline posts. The Government has estimated that this will save "at least" £0.12 billion.

The analysis above in relation to pay highlights the fact that wage restraint will only be able to take so much of the strain of reduced public sector activity. Similarly, recruitment freezes may not act quickly enough and are, in any case, outside of central government control in most instances (while the Government is directly responsible for employment in the civil service, staff issues in the NHS, schools, police, local authorities and in many public corporations and arms length bodies are matters for local managers). Therefore more explicit job cuts appear inevitable. As in the private sector, those most likely to lose their jobs during such a period of rationalisation are the lowest skilled members of the workforce. We have shown in Section 2 that this means low earners.

Low earners suffering job loss during the private sector downturn have been helped somewhat by the Government's active labour market policies. However, we recommended in our report on the experiences of low earners in the recession that more could be done. These recommendations remain as relevant during a period of rationalisation in the public sector as they did at the height of private sector job losses:

> *Ensuring that Jobcentre Plus is configured to help low earners is essential: before they even walk through the door, many low earners do not perceive that Jobcentre Plus is for them and early evidence suggests that there remains a mismatch between what advisers have been trained to do, and what low earning clients need.*
>
> *The recession has accelerated the reforms to the welfare-to-work system which were already underway. A shift towards active labour market policies is a step in the right direction, but it remains the case that more could be done to respond to the needs of low earners, many of whom already have the basic qualifications and employability that the current system is designed around. For example, enhancing the existing 'light touch' skills assessment that*

takes place 13 weeks after someone has lost their job could make all the difference to low earners – rather than making them wait the current 26 weeks before being offered a formal skills assessment. This would need to be coupled with stronger incentives for Jobcentre Plus staff to refer their clients on to skills development and training courses.

The system also needs to be geared more effectively towards employability and sustainability. This will require a cultural shift, which can be encouraged by refining existing metrics and targets. For example the Social Market Foundation has argued that measuring someone's total time out of work over the past two years, rather than their total time on benefit, is likely to be a better guide to understanding what further support that individual needs to be ready for work.[146] *We agree, and would also argue for an extension in the definition of sustainable work. 'Sustainable' needs to mean 12 to 18 months, not 13 weeks – and welfare-to-work providers should be encouraged to focus on this goal by a system of escalating payments. This approach should help to strengthen the connections between out-of-work and in-work support, which are not as strong as they need to be in the current system.*[147]

A crucial factor in determining whether low earners losing jobs in the public sector will be able to find work elsewhere is the pace of recovery in the private sector. If new jobs are created in this half of the economy, then labour market conditions may pick up sufficiently for low earners to share in the gains. If, however, demand in the private sector remains sluggish and employment growth is slowed by the amount of spare capacity within firms that held onto workers during the recession, then the lack of opportunities in the public sector could mean that some low earners face extended periods out of work. Once again this problem highlights the importance of making the pace of fiscal consolidation contingent on the strength of economic recovery.

It is worth noting that, as with pay, this consideration again has a regional element. Since the start of the recession, unemployment has grown most outside of London and the South East; the same areas in which the public sector form the highest proportions of the workforce. It is quite possible then that public sector job cuts will reinforce geographical divisions between those areas with strong and weak labour markets.

[146] SMF, *Vicious Cycles: sustained employment and welfare reforms for the next decade*, 2009

[147] Resolution Foundation, *Closer to Crisis?* 2009

We favour the use of wage restraint as a means of limiting the numbers of job cuts required in the public sector, because we believe that redundancies will hurt low earners more than higher earners. However, we acknowledge that this approach has its limitations, because of the likelihood of future catch-up in public sector salaries if they are pushed too low relative to the private sector.

Therefore, in the interests of implementing a permanent reduction in the pay bill, we acknowledge that some job loss is inevitable and that this should be based on an assessment of priorities rather than any artificial protection of the low paid. Instead, we believe that the Government should focus its attention on ensuring that low earners have the support necessary for making the transition out of work and back into employment or training. Without specific consideration of their needs, there is a danger that they will be lost to the labour market permanently. We also feel that the risks associated with cutting jobs in the public sector while opportunities remain restricted in the private, add to the argument for explicitly linking the pace of fiscal consolidation to the strength of economic recovery.

Reforming public sector pensions

As discussed above, public sector workers are particularly advantaged compared to members of the private sector workforce in relation to pension provision. Public sector workers are more likely than private sector staff to be members of an occupational pension scheme, particularly defined benefit (DB) schemes. In addition, the DB pensions that they receive are, on average, more generous than the DB pensions received by private sector employees. The IFS has estimated that, while the public-private sector pay differential is around 5 per cent on average, the differential for pensions is 12 per cent.[148]

The extra generosity of public service pensions is founded in part on taxpayer subsidy. The actuarial process used by the Government means that employee and employer contributions fall short of the annual cost of pensions. One estimate puts the value of this subsidy at £28 billion a year.[149]

Recent reforms – including increases in normal pension age and moves from final salary to average salary pension payments – are set to reduce the generosity of public sector pensions for new entrants, although not by the full size of the existing differential.

PBR 2009 also announced that 'cap and share' provisions would be implemented for teachers, civil service, NHS and local government pension schemes. These are designed to limit the liability of the Government if improved longevity means that

---

[148] IFS, *Green Budget*, February 2010, p235

[149] See for example, Vince Cable, *Tackling the fiscal crisis: A recovery plan for the UK*, September 2009 (Reform), p42.

public sector pension payments become more valuable than accounted for in the Treasury's actuarial process. If such increases occur, the additional costs will initially be shared between employees and the employer in the form of higher contributions. Beyond a cap, however, costs will be borne entirely by employees either in the form of higher contributions or reduced benefits. The Government estimated that this would save £1 billion a year from 2012-13, although this saving is relative to a cost that had not previously been accounted for.

Each of these measures makes little difference to the overall cost of public service pensions in the short-term: while they may reduce the future value of unfunded public pensions, they do nothing for the current deficit. One means of making more immediate savings would be to increase the contributions that employees make now in respect of their future pensions. This would effectively represent a pay cut, because take home pay would be reduced. The IFS has estimated that a 7.5 per cent levy on public sector workers (such as has happened in Ireland) would raise up to £9 billion a year.[150] Clearly, however, this would represent a big hit on public sector workers. Total savings would be lower if a smaller levy was imposed.

From a distributional perspective, a flat-rate increase in contribution rates would share the burden equally. As with the option for pay cuts discussed above, a more progressive option could be to increase contribution rates by more for higher earners.

4.4 Conclusions

In Section 3 we considered a range of broad principles relating to fiscal consolidation. Having considered the impact of more specific policy proposals on low earners in this section, a number of conclusions can be drawn.

First, there are no painless solutions. While we have argued that low earners should be protected to some extent from the worst of the adjustment, it is clear that the group cannot be insulated entirely.

Secondly, as Tables 16-18 in Appendix 1 show, the least bad options from the perspective of low earners are primarily tax-based – in particular, taxes on wealth and income – while there are very few absolute spending cuts which suit the group more than other members of society. To the extent that they do – cutting low cost home ownership programmes for instance – it is because the existing spending is poorly targeted from a low earner perspective. Given that spending cuts are set to shoulder a larger share of the consolidation than tax rises, it is important that the Government is prepared to share the burden of adjustment by introducing tax and spend measures that explicitly target higher earners.

---

[150] IFS, *Green Budget*, February 2010, p236

Thirdly, any proposals that involve means-testing are likely to place low earners at risk. Relevant thresholds are likely to fall frequently within the group's range of incomes, meaning that some low earners miss out on support, while others face disincentives in relation to working and saving. While it will be important to use compensating measures to help protect the most vulnerable members of society from tax rises, benefit cuts and user-charging, the Government must bear in mind the danger that this approach exposes the same group time and again.

Finally, low earners will be affected by fiscal consolidation not just as consumers and funders of public services, but also as public sector employees. For the 1.8 million low earners working in the public sector, fiscal consolidation is likely to have the same impact as recession in the wider economy has had on other members of the group. That is, they are likely to be more exposed than other public sector staff. For that reason, we favour pay flexibility over job cuts, but we accept that a permanent reduction in state activity is likely to require redundancies.

We therefore urge the Government to provide support for those low earners losing their jobs by ensuring that labour market policies meet the needs of the group. This includes: recognising that out-of-work low earners would benefit from a balance of work experience and supported job search, rather than one to the exclusion of the other; making sure that JobCentre Plus identifies and responds to the particular circumstances of low earners; responding to the fact that low earners already tend to have the basic qualifications and employability that welfare-to-work programmes are designed around; and gearing welfare-to-work more effectively towards employability and sustainability.

Conclusions

The UK's annual budget deficit is set to reach 11.1 per cent of GDP in the current financial year, the highest level as a share of national income since World War II, and equivalent to £156 billion in cash terms. Of this, around £65 billion is thought to be a permanent deficit – that is, it would exist even in the absence of recession. Tackling this deficit is quite rightly the priority of the new Government and promises to be a painful process, affecting all households in the UK. However, in the absence of special consideration, one group looks particularly exposed to the consequences of fiscal consolidation – low earners.

Low earners operate at the margins of the mixed economy and are therefore by definition squeezed: too poor to access all of the opportunities provided by private markets, and too rich to qualify for significant state support. They have not shared equally in the spoils of economic growth in recent decades; growing poorer not just in relation to richer households, but also in relation to those households below them in the income distribution.

The recession highlighted the exposure of the group. In relation to benefit-dependent households, low earners had jobs to lose, mortgages and credit arrangements to default on and a lack of experience in accessing support from the state. In relation to higher earners, the group had smaller safety nets – in terms of savings, insurance and redundancy payments – and displayed less ability to return rapidly to work following job loss. While the economy is now in recovery, low earners are likely to continue to struggle because of ongoing weaknesses in the labour and credit markets.

The difficulties low earners face in accessing private market solutions, combined with their position on the cusp of state support mean that the group risks being disproportionately affected once again in relation to fiscal consolidation. Therefore, in developing a plan for reducing the deficit, the new Government must make sure that the needs of low earners are not overlooked. While low earners should not be entirely insulated from the process, their position and needs require special consideration to ensure that they do not bear the brunt of adjustment pain.

In designing its timetable and detailed route map for closing the deficit, the Government should have consideration for three criteria: *fairness*, *growth* and *sustainability*. Fairness has obvious implications for low earners, but growth also matters to the group: with direct and indirect support from the state much-reduced, private sector employment prospects for low earners will become even more important. Low earners will benefit also from a regard for sustainability because of the importance of ensuring the consolidation process proves successful. By presenting a final fiscal plan as a single package, the Government can highlight the trade-offs between these criteria and between different groups in society, to make it clear how the pain of adjustment is being shared.

From the perspective of fairness, the pace of fiscal tightening should be made contingent on the state of the economy, because any return to recession provoked by the withdrawal of government activity would once again fall heaviest on low earners. This contingency could take the form of inclusion in the timetable set out in the emergency Budget of a series of tests designed to assess whether the private sector has gained self-fulfilling momentum, along with details of how the Government might react to domestic and global economic performance and events that are outside of its central forecasts.

From the perspectives of growth and sustainability, there should be equal flexibility to accelerate deficit reduction if the economy performs better than expected. Commitment to this would both reassure investors that the Government is serious about tackling its fiscal problem and help to ensure that the total period of painful adjustment is kept to a minimum.

Spending cuts are expected to account for the majority of the fiscal tightening, However, there is clearly still a role for closing some of the deficit via raising tax revenues. This role stems from both the economic reality that the size of the hole is such that spending cuts can only take so much of the strain, but also from the likely political reality of the limits of public acceptance of cuts in services. Fairness dictates that the mix of mechanisms should be designed to ensure that low earners are not disproportionately affected by the adjustment.

In terms of growth, economic theory and evidence from past consolidation episodes suggests that adjustments that place a greater reliance on spending cuts than on tax increases are more likely to be beneficial, and the new Government is committed to such an approach. To this end, while cuts in areas of current spending are likely to be particularly difficult for low earners, they should not be avoided simply by cutting investment in the future of the economy. Similarly, tax policies should be selected with reference to keeping disincentives and distortions to a minimum.

In order to ensure that any cost-cutting and revenue-raising measures introduced make headway into the structural deficit, it is important that they are designed with sustainability in mind. This means tackling some of the big areas of spending and revenue – health, education, income tax and VAT for instance. It also means taking the opportunity for reform alongside fiscal adjustment: reform of tax mechanisms and reform of public service delivery. Such restructuring could both improve the efficiency of taxes and spending, and so help the process of closing the deficit, and improve the interaction that all citizens, including low earners, have with the machinery of government.

In relation to the fairness of more specific policy proposals from the perspective of low earners, a number of conclusions can be drawn. First, there are no painless solutions. While we have argued that the group should be protected to some extent from the worst of the adjustment, it is clear that they cannot be insulated entirely.

Secondly, the least bad options from the perspective of low earners are primarily tax-based – in particular, taxes on wealth and income such as capital gains tax and income tax – while there are very few absolute spending cuts which suit the group more than other members of society. To the extent that they do – cutting low cost home ownership programmes for instance – it is because the existing spending is poorly targeted from a low earner perspective. Given that spending cuts are set to shoulder a larger share of the consolidation than tax rises, it is important that the Government is prepared to share the burden of adjustment by introducing tax and spend measures that explicitly target higher earners.

Thirdly, any proposals that involve means-testing are likely to place low earners at risk. Relevant thresholds are likely to fall frequently within the group's range of incomes, meaning that some low earners miss out on support, while others face disincentives in relation to working and saving. While it will be important to use compensating measures to help protect the most vulnerable members of society from tax rises, benefit cuts and user-charging, the Government must bear in mind the danger that this approach exposes the same group time and again.

Finally, low earners will be affected by fiscal consolidation not just as consumers and funders of public services, but also as public sector employees. For the 1.8 million low earners working in the public sector, fiscal consolidation is likely to have the same impact as recession in the wider economy has had on other members of the group. That is, they are likely to be more exposed than other public sector staff. For that reason, we favour pay flexibility over job cuts, but we accept that a permanent reduction in state activity is likely to require redundancies.

We therefore urge the Government to provide support for those low earners losing their jobs by ensuring that labour market policies meet the needs of the group. This includes: recognising that out-of-work low earners would benefit from a balancing of work experience with supported job search, rather than one to the exclusion of the other; making sure that JobCentre Plus identifies and responds to the particular circumstances of low earners; responding to the fact that low earners already tend to have the basic qualifications and employability that welfare-to-work programmes are designed around; and gearing welfare-to-work more effectively towards employability and sustainability.

This last finding points to a wider conclusion. While ensuring that the structural deficit is closed in a way that is both fair and good for economic growth is quite rightly the priority of the new Government, we believe that the fundamental review of the role of the state associated with this period of consolidation provides an opportunity to get to grips with some of the gaps in the mixed economy that prove so problematic for low earners.

While accepting that it will be necessary to share some of the adjustment pain with the low earners group, we believe that cost reductions should be balanced by what a commercial enterprise would call investment – investment in programmes designed to give people the ladders and support to maintain their own economic independence. That is good for them and their families, and good for the UK as a whole.

Appendix 1: Summary of low earner impact assessment

Tables 16-18 summarise the assessments detailed in Section 4, dividing options for consolidation into those that fall heaviest on low earners, those that are distributionally neutral and those which have less of an impact on low earners than on other members of society. The key is set out below.

Where feasible, each option is presented alongside an indication of the potential magnitude of annual revenue or savings that it might generate – as discussed in the detailed analysis in Section 4 – in order to highlight the contribution that it could make to the overall consolidation package. These estimates are highly uncertain, and are often based on one specific approach to introducing the mechanism: alternative arrangements might significantly alter the impact of the option.

The figures should not be added up, because there is likely to be some direct duplication – for example, a carbon tax would remove the need for some other environmental taxes – and some indirect duplication whereby introduction of one measure would make introduction of another politically or practically impossible.

In relation to a number of options, revenues and savings are not quantifiable because of the open-ended nature of the proposal or because of a lack of appropriate data.

Key

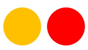
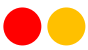
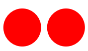
	Low earners unaffected, or significantly less affected than other income groups
	Low earners little affected, or less affected than other income groups
	Low earners slightly less affected than other income groups
	Broadly neutral distributional impact/not possible to make an assessment
	Low earners slightly more affected than other income groups
	Low earners quite affected, or more affected than other income groups
	Low earners significantly affected, or significantly more affected than other income groups

Table 16: Least-bad consolidation options for low earners

Achieving public service efficiencies	*up to £20bn*
Increasing capital gains tax rate	*~ £3.2bn via alignment with income tax rates*
Implementing public service resource transfers	*na*

Increasing National Insurance Upper Earnings Limit	*~ £4.2bn via raising to £100k a year*
Removing personal allowance for higher rate income tax payers	*~ £4.1bn*
Restricting pension contribution tax relief	*~ £4.1bn via restricting relief to 20%*
Introducing ad-valorem tax on properties over a certain threshold	*£3-£4bn via average 0.5% levy on properties above £500k*
Charging capital gains tax at death	*~ £0.2bn*
Raising inheritance tax rate	*~ £0.01bn via 1 percentage point increase*
Increasing the number of lifetime gifts covered by inheritance tax	*na*

Increasing income tax rates	*~ £5.5bn via 1p increase in all rates*
Cutting public sector pay	*~ £5.5bn via freezing wages for two and a half years*
Increasing National Insurance rates	*~ £5.0bn via 1 percentage point increase in employee or employer rates*
Charging capital gains tax on primary residence	*up to £5bn*
Extending VAT to financial services	*up to £2.8bn*
Cutting low cost home ownership programmes	*up to £2bn*
Charging higher interest on student loans	*up to £1.2bn*
Reducing inheritance tax threshold	*~ £0.03bn via cut to £320k*
Cutting capital gains tax threshold	*~ £0.02bn via £500 cut for indlviduals and £250 cut for trustees*
Introducing local income tax	*could replace £24.4bn raised via council tax or go further*
Introducing ad-valorem tax on all properties	*could replace £24.4bn raised via council tax or go further*

Table 17: Consolidation options with broadly neutral or unmeasurable distributional impact

Reforming public sector pensions	*~ £9bn via increasing employer contributions to 7.5%*
Cutting transport spending	*~ £5bn on assumption that department will account for 10% of all cuts as in 2010-11*
Increasing standard rate of VAT	*~ £4.5bn via 1 percentage point increase*
Reducing limit on tax-free lump sum pension drawdown	*up to £3.2bn*
Increasing corporation tax rates	*~ £3.2bn via removal of small companies discount rate*
Increasing stamp duty land tax rates	*~ £3bn via 1 percentage point increases in all rates*
Increasing business rates	*~ £2.3bn via 1% increase in all rates*
Taxing universal benefits	*~ £1.2bn via taxing Child Benefit*
Reducing stamp duty land tax thresholds	*~ £0.4bn via £5k reduction in all thresholds and removal of zero-rate threshold*
Removing inheritance tax exemptions	*up to £0.35bn*
Increasing stamp duty rates on share transactions	*~ £0.3bn via 1% increase in rates*
Increasing vehicle excise duties	*~ £0.06bn via 1% increase in all rates*

Table 18: Worst consolidation options for low earners

Removing exemption of employer pension contributions from National Insurance	*up to £8.3bn*
Means-testing universal benefits	*~ £5.1bn via combining Child Benefit with Child Tax Credits*
Cutting spending on skills training	*up to £4.5bn*
Cutting National Insurance thresholds	*~ £0.7bn via cutting employer and employee thresholds by £2 a week*
Cutting generosity of maintenance grants for students	*up to £0.5bn*
Cutting income tax thresholds	*~ £0.3bn via cutting basic and higher rate limits by 1%*

Introducing a carbon tax	*~ £10bn via £21 per tonne CO2 charge and reductions in other environmental taxes*
Means-testing tax credits more aggressively	*~ £1.3bn via increasing main taper to 49%*
Cutting bus industry fuel grant	*up to £0.4bn*
Increasing air passenger duty rates	*~ £0.03bn via 1% increase in all rates*
Tightening benefit eligibility criteria	*na*
Increasing class sizes	*na*
Cutting public sector employment	*na*

Table 18 cont...

Introducing VAT to zero-rated items	*~ £24.8bn via charging at standard rate of 17.5%*
Reducing long-term care funding	*up to £10bn*
Cutting all benefits values	*~ £4.1bn via freezing rates in cash terms*
Cutting universal benefits values	*up to £4bn via scrapping Winter Fuel Payments and freezing basic State Pension*
Increasing reduced rate of VAT	*~ £3.9bn via raising to standard rate*
Removing pensioner tax allowance	*~ £2.8bn*
Increasing council tax rates	*~ £2.5bn via 1% increase in all rates*
Cutting tax credits values	*~ £2.2bn via cutting various elements by £100*
Reducing investment in house building	*~ £1.5bn based on proportion of cuts in 2010-11 accounted for by housing*
Cutting Sure Start funding	*up to £1.3bn*
Increasing fuel duties	*~ £0.5bn via 1p per litre increase in main rate*
Capping university places	*~ £0.5bn for every 20,000 students denied entry*
Increasing alcohol and tobacco duties	*~ £0.2bn via 1% increase in duties*
Increasing the starting rate of tax for savings income	*~ £0.1bn*
Extending congestion charging and road pricing	*na*
Letting NHS waiting lists grow	*na*
Increasing user-charging in the NHS	*na*
Scaling back free nursery care	*na*
Charging for local authority services	*na*