Briefing

Resolution Foundation

Will future tax cuts reach struggling working households?

Briefing for the Resolution Foundation by Donald Hirsch

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This briefing note was prepared for the Resolution Foundation by Donald Hirsch, Director of the Centre for Research in Social Policy at Loughborough University, and does not necessarily reflect the views of the Resolution Foundation.

Introduction

All political parties today say they want to help working people on low to middle incomes who struggle to make ends meet. Under the last government, in terms of direct financial support, this was achieved mainly through in-work tax credits. Today, the emphasis is shifting in favour of cutting taxes in ways that have the objective of helping low earners. The current government has pursued this through raising the personal tax allowance. As the 2015 election approaches, all parties may develop plans for tax cuts in the next parliament; already the opposition has said it wants to re-introduce a starting 10p rate of income tax[1] and senior Liberal Democrats have made clear that they would like to raise the personal allowance above the £10,000 level promised and achieved in this parliament to £12,500.[2]

However, all such plans risk competing and even conflicting with the government's flagship welfare reform: Universal Credit. Under UC, tax cuts will not, in large part, reach low to middle income working households. This is because Universal Credit is calculated on the basis of net income, meaning that any tax cut that boosts a household's income also reduces their UC support. Put another way, any tax cut will give with one hand and take away immediately most of the gains with the other. No party has questioned this basic aspect of UC's design. The result is that, as things stand, any promise of post-election tax cuts will do little to help a large swathe of low to middle income working households.

This briefing looks at how exactly tax cuts interact with Universal Credit and quantifies how little low to middle income working households will keep from a higher personal allowance or a 10p tax rate under UC. It also suggests a simple way in which the Government could ensure that the benefits of tax cuts do flow through to the pockets of the three million taxpayers who claim UC. Any party proposing tax cuts that does not adopt this or an equivalent policy cannot claim to be targeting low to middle income households by cutting taxes.

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[1] 14 Feb 2013, Ed Miliband backs 'mansion tax' to fund 10p tax rate return, BBC News (14/02/13), http://www.bbc.co.uk/news/uk-politics-21453444
[2] 18 Sep 2011, Lib Dems want to raise income tax threshold to £12,500, http://www.guardian.co.uk/politics/2011/sep/18/lib-dems-income-tax-threshold

Tax cuts to help low earners

In recent years, there has been an increased emphasis on tax cuts as a means of helping low earners. The predominant approach of the current government has been to raise the level at which tax starts to be paid: to increase the personal tax allowance. As attention turns to the next parliament, other ideas have been mooted, with the opposition proposing a "starting rate" of tax lower than the basic rate, applying a 10p rate of tax to the first tranche of taxable earnings. Leading figures from both parties in the Coalition have suggested further raising the personal allowance.

The two different approaches of raising the personal allowance and introducing a 10p starting rate of tax are similar in many ways. Raising the tax allowance by £1,000 would have an almost identical effect to introducing a 10% tax band for the first £2,000 of income: in both cases this would reduce the post-tax income of almost all taxpayers by a flat rate £200. The gains of either policy can also be shared with 40p taxpayers, or alternatively focused only on basic rate taxpayers, by lowering the 40p tax threshold. (See box below.) In this paper, we assume an approach that limits the gains to basic rate taxpayers, meaning that all those earning more than £2000 in taxable income and below the higher-rate tax threshold would benefit equally.

A small subset of people, those with only a very small amount of taxable income, would experience slightly different outcomes under the two policies. Someone earning only £11,000, for example, and so paying 20% tax on only £1,000, would benefit in full from a £1,000 rise in the tax allowance, gaining £200, but would get only half the benefit (£100) of a new 10% tax on the first £2000 of income above £10,000. As a flipside of this, the number of people benefiting from a slightly lower marginal tax rate would be higher under a 10p tax band, which would extend over a larger band of earnings than an increased allowance. These are fairly minor differences in what are otherwise very similar policies.

The question of whether tax cuts are a good way of providing financial support is a live one even prior to any consideration of Universal Credit. Tax cuts are in general ill-targeted and are *not* focused on low earners. If a higher allowance or a 10p rate of tax is introduced without lowering the 40p threshold, all earners benefit aside from the *very* highest and the *very* lowest earners. Even if the gains are limited to basic rate taxpayers by lowering the 40p threshold, all basic rate taxpayers benefit equally from a flat cash gain, again excluding the very lowest earners. However, unlike a cut in the *rate* of tax, a personal allowance increase (or a 10p tax band) does help lower earners the most in proportion to their earnings.

A personal allowance increase or 10p tax rate is therefore *relatively* progressive *compared to other forms of tax cut* and when at looked on an individual basis. This is not the same as saying that either approach is progressive in the sense that it gives proportionately more help to people with lower *household incomes* – that is, once we consider the earnings of everyone in the household, plus benefits and minus taxes.

Analysis of the impact of increasing the personal allowance on the basic of household income shows that, even under the most progressive approach that can be taken (limiting the gains to basic rate taxpayers by lowering the threshold for 40p tax), the greatest gains, proportionate to their income, go to households in the upper middle part of the distribution (see box).[3] This is partly because tax cuts do not benefit people who are not working or who are working but already earning too little to pay tax. It is also because relatively higher income households are more likely to contain two earners, therefore benefiting twice from a tax cut.

Raising tax allowances: who benefits?

When the Coalition first raised tax allowances in 2011, they ensured that the only beneficiaries were basic-rate taxpayers – i.e. people paying tax at the main 20% rate. They ensured that higher-rate taxpayers would not gain by lowering the earnings at which higher-rate tax starts to be paid enough to counteract entirely the benefit of a higher tax-free allowance. This focused the gains of the allowance increase on basic rate taxpayers but also created more 40p taxpayers.

Subsequently, increases in tax allowances have been more generous to higher earners. By raising the earnings above which people pay 20% tax, but not lowering the earnings above which they pay 40%, the government has ensured a flat benefit for all taxpayers in the 20p and 40p tax bands. This excludes people earning above £118,880 in 2013/14, who receive no personal allowance.

The main calculations in this paper assume the first, more "progressive" method, which gives nothing to higher earners. This demonstrates the extent to which gains from higher tax allowances can potentially be concentrated on low to middle earners. The same adjustment could, potentially, be used to restrict the benefit of a 10p starting-rate tax band to people not paying higher-rate tax. If our calculations had taken a different approach, instead assuming a continuation of the government's more recent approach, the results would be less progressive.

[3] Again, this assumes that the benefits of the allowance gain are focused only on basic rate taxpayers by lowering the threshold for the 40p rate of tax.
http://www.resolutionfoundation.org/media/media/downloads/RESOLUTION_FOUNDATION_BUDGET_REACTION.pdf

How Universal Credit and tax allowances will conflict

Whatever one's views on the above debates about tax cuts and low to middle income households, the introduction of the government's flagship welfare reform, Universal Credit, introduces a major new challenge for any politician hoping to help struggling households with tax cuts. The design of Universal Credit means that, unlike under today's tax credit system, cuts in taxes for low to middle income working families will be counteracted by reductions in a household's Universal Credit entitlement. Put simply, under UC, tax cuts will not, in large part, reach low to middle income working households.

The reason can be summed up as follows. When someone's taxes are cut – whether through an allowance increase or a 10p tax rate – this increases their post-tax income. However, in calculating the amount of Universal Credit a household receives, the government provides 65 pence less UC for each pound the family's income increases *after tax*. This 65 per cent figure is known as the UC 'taper'. Consequently, having cut taxes with one hand, it takes away nearly two thirds of the gain with the other.

Specifically, a tax allowance hike of £1000 would be expected to lead to a gain of £200 in post-tax income. However, this increase in post-tax income leads to a reduction of £130 in Universal Credit, and therefore a net gain of just £70. This means that rather than *every* taxpayer gaining a flat rate £200, those in the greatest need gain barely a third this amount – while those higher up, and not in receipt of Universal Credit, gain the full amount. With a tax cut achieved through a 10% tax band, the effect on Universal Credit is the same. Nearly two thirds of any benefit would be lost for those in UC.

This interaction between taxes and in-work benefits does not apply to large parts of the existing welfare system. While Council Tax Benefit and Housing Benefit are already assessed on the basis of net income, tax credits are assessed on the basis of *pre*-tax income, meaning that a tax cut has no effect on the amount of tax credit support received. The result is that, once UC is up and running (it is being phased in from later this year), tax cuts, already a relatively inefficient way of supporting low to middle *income* households, will become almost exclusively a policy for helping households on middle and higher incomes. For some time, as UC is rolled out gradually, those who happen to be on the new system will receive a far smaller gain from tax cuts than those remaining on the existing system.

Making tax cuts pay for people on Universal Credit

How could UC be reformed so that tax cuts reach low to middle income families? The answer is that the gains from tax cuts will need to be offset by a change in UC. This can be done by raising the "disregard": the amount of income that above which UC starts to be reduced ("tapered"). Just as tax allowances allow people to earn a certain amount before being subject to tax, so the UC disregard allows them to earn a certain amount before the credit starts to be withdrawn. **Raising the disregard by 20 per cent of any increase in the tax allowance would be enough to ensure that the gains flow through to low to middle income working households.**

Under this approach, if the tax allowance rose by £1000, and the UC disregard rose by £200, a family's post-tax income would then attract the same UC award even after their post-tax income rose by £200 as a result of the higher allowance. Similarly, a new starting-rate band taxed at 10% would need to trigger an increase in the UC disregard by 10% of the width of any new 10p tax band in order to offset any clawback of the gains from the tax cut. It is worth noting that this would only be sufficient to protect households that contain only one person paying tax. Households containing more than one taxpayer would face a larger clawback and would not be fully compensated by this move.[4]

Clearly ministers and officials are aware of this issue but there is, as yet, no public commitment to altering UC in this way. The need to change planned UC disregards in response to tax cuts from 2014 onwards is clear. Whether or not UC will also need to be changed in response to the increases in the personal allowance that are planned for April 2013 is a more difficult question. The answer comes down to whether this new, higher personal allowance was already borne in mind when the disregards for UC were designed in the first place. With the tax allowance rising by £1335 this April - the biggest ever increase - this is a question of some importance. If the disregards for UC were designed without taking into account the April 2013 planned allowance increase, our calculations reveal for the first time that the government will in effect be saving around £500m a year from the money being spent on the April 2013 allowance increase, once UC is introduced and most of the gains of this allowance increase are clawed back from UC households.

Any party claiming to offer tax cuts that benefit low to middle income working households under UC will need to make a specific commitment to raise disregards each time it cuts income tax. Specifically, UC disregards will need to be increased by 20% of any increase in the personal allowance and, in the case of a 10p tax band, by 10% of the width of the new band. This increase should be above the amount by which disregards would otherwise have been increased – which has been set at 1% a year for the next three years.

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[4]This treatment of two earner households under Universal Credit also raises wider issues beyond the scope of this paper. Under Universal Credit, first earners will receive, in effect, a larger disregard than second earners, undermining work incentives for second earners (overwhelmingly women). This has prompted some to call for the equal treatment of first and second earners. See p.103, *Gaining from Growth: the final report of the Commission on Living Standards*, Resolution Foundation (2012).

Universal credit as an alternative way of improving incomes among low to middle income families: the options

The above discussion also raises a bigger question over the best way to help low to middle income households. The paper closes by considering a range of options for using scarce money to support struggling households through Universal Credit rather than through tax cuts. There are various ways to do this, each benefitting different groups to different degrees:

First, the ***basic entitlement level of UC*** can be raised. This gives a flat-rate increase to a wide range of low to middle income households, including those not working, those working and below the tax threshold and those working and paying tax, but on low family income.

Second, the ***UC "disregard"*** can be raised not only to allow families to keep income from tax cuts but also simply to keep more of what they earn. Any change in the disregard has an impact exclusively on working households. Just as raising the tax allowance gives money to individuals by subjecting less of their income to tax, so raising the disregards subjects less income to the "taper". However, since the taper rate is 65% and the basic tax rate 20%, a given increase in the disregard creates a gain three times as large as the same increase in the tax allowance, for a single earner family. A given increase in disregard will give the same amount to all working families on UC earning above this level.

Third, the ***UC taper rate****,* at which additional (post-tax) income triggers a reduction in UC, could be changed from its present level of 65%. This would help to "make work pay" for recipients of UC as earnings increase, for example by working extra hours. In practice, the greatest beneficiaries would be those at the top of the range of incomes eligible for UC – those on low but not the lowest earnings and in particular those whose high needs (for example in large families or with expensive childcare) give them substantial entitlements.

Importantly, all of these mechanisms differ from the impact of a tax cut because they are assessed on the income of the *family unit*[5] rather than the individual, and therefore have an impact at the household level. Table 1 sets out a summary of these options and who gains from each.

[5] Defined as a single adult or a couple plus any dependent children

Table 1: Three ways of giving more help through Universal Credit

Measure	What it gives	Who it helps	Who it helps most
Increased UC entitlement	Higher basic level of UC	All UC recipients, in and out of work (or could target to certain family types)	Equal help to all on low to middle incomes, in and out of work
Increased UC disregard	Extra tranche of income ignored for UC assessment	Most working UC recipients	Equal help to all above disregard level
Lower UC taper	Slower withdrawal of UC as income rises	Most working UC recipients	Families with high needs and modest incomes but not the lowest incomes

Policy options: are tax cuts the best way of helping struggling households?

This section closes by setting out briefly the relative costs of helping particular families and reaching different numbers of beneficiaries, whether through tax cuts or Universal Credit.[6] The different approaches of providing support through tax cuts and through Universal Credit have different effects in part because they reach different populations.[7] By way of context:

- There are between 18 and 19 million basic rate taxpayers of working age
- Around 10.5 million adults live in the 7.7 million families who will receive Universal Credit[8]
- Only around 3 million of these adults will be working and earning enough to pay income tax
- Around 1 million adults in UC will be earning too little to pay income tax at the same time as their incomes are subject to the UC taper because their combined family earnings are above the UC disregard.[9]
- Most adults in families receiving UC will not be working, although in many cases their partners will be.

These figures underline the relatively small overlap between those who pay income tax and those benefiting from Universal Credit. This makes it inevitable that helping households through tax cuts or through Universal Credit has a very different impact.

Given these relative scales, Table 2 gives a sense of the impact that can be achieved through four illustrative policy options. Column 2 shows the cost of the policy (in the case of the personal allowance, this is initially measured after savings from the UC clawback are taken into account and assuming that the gains are limited only to basic rate taxpayers by lowering the 40p tax threshold). Column three then shows the gains for each working family on Universal Credit. Column 4 then gives a measure of the efficiency of the policy – the gains that each household gets for each £1bn the government has spent. The policies are not proposals but rather are designed to illustrate how different approaches to supporting families can provide very different value for money in terms of helping certain groups of individuals.

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[6]The numbers in this section are based on author estimates, mainly based on analysis of individual earnings and Universal Credit status in the Family Resources Survey. Thanks to Matthew Whittaker of the Resolution Foundation for supplying data processed from the survey. Information has also been drawn from the DWP's Universal Credit Impact Assessment (December 2012).
[7]Figures calculated for 2013-14 tax year unless otherwise specified.
[8]Based on earnings and income data from Family Resources 2009/10 uprated to 2012/13 and applied to latest published UC specification in 2013 prices. 7.7m families refers to benefit units.
[9]Estimate based on numbers facing various withdrawal rates in DWP (2012, op cit)

Table 2: Examples of policy options, their cost and gains for working families with children on Universal Credit

Policy	Estimated cost	Overall gain per week per working family on UC[10]
Tax cutting options		£1.35
1) Raise tax allowance by £1000	£3.2 bn	£3.85
2): Raise tax allowance AND UC disregard so that UC claimants keep the gains*	£3.6 bn	
Other options		£2.49
3) Raise UC disregard by £200	£0.4 bn	£5.20
4) Raise UC by 2.5% a year rather than 1% a year over three years	£2.1 bn	a) £13.30 b) £26.40
5) Lower UC taper rate from 65 to 55% a) On £10k/yr** b) On £20k/yr**		

* The actual cost of this policy in 2013, to counteract the effect of a £1,335 increase in tax allowances, would be around £500m.
** Earnings of single worker in couple

The first of these policies, raising the tax allowance, gives a small sum to a large number of people. As explained above, a lower-rate starting tax band such as a 10p rate would have a very similar effect. This expensive policy therefore gives relatively little to each household, with people on Universal Credit gaining only 42p a week for every £1 billion that the policy costs the Exchequer (assuming that the government allows gains to be clawed back through the system).

If instead the UC disregard is increased along with the personal allowance to avoid the clawback of the income gain (Option 2) – passing the test we set out earlier in this paper – then UC recipients gain around £1 a week for every £1 billion invested. This means they are gaining the same amount as other taxpayers and more than doubles the efficiency of the policy in terms of the help it gives to low to middle income working households.

Interestingly, though, raising the UC disregard could also be considered as a policy option in its own right (Option 3), without raising the personal tax allowance. As shown in Table 2, this is in fact a particularly cost-effective way of raising the incomes of low to middle income working households on UC. Roughly 4 million working people (3 million of whom earn enough to pay tax, and 1 million of whom do not) who receive Universal Credit, but earn too much to get the maximum amount, gain 65p for every £1 extra income that the system disregards. If the Treasury had spent as much raising these disregards as it had in 2013/14 raising the tax allowance, these households would have gained around £25 a week rather than the £1.80 they actually gained from the allowance.

Of course, policymakers have a range of objectives in mind when trading of tax and benefit reforms, including helping those in the middle and upper-middle portions of the distribution. However, this comparison brings home that, looked at simply in terms of helping low and middle

[10]Columns 3 and 4 show **weekly gain for single earner family with two children receiving UC and paying tax.**

income working families on UC, raising the UC disregard is around 15 times as efficient as raising the tax allowance.

Table 2 also looks at two other options for improving support through Universal Credit and the effect they have on working families on low to middle incomes. Option 4 is to raise the rate of UC itself. As an example, it considers the cost of exempting the children's element of UC from the decision to limit all benefit rises to 1 per cent a year for three years starting in April 2013. If instead the UC rates for children were increased in line with forecast CPI inflation, all low to middle income families with children would avoid a real cut in their income of about £5 a week for two children over those three years. Note, however, that because this benefit would also go to non-working families, the average working family would benefit by less, for a given level of investment, than under the previous policy scenarios. Nevertheless, this reform would still help low to middle income working families on UC far more for a given cost than raising tax personal allowances.

The final policy considered in Table 2 is reducing the rate at which Universal Credit is reduced (tapered) as earnings rise. The scenario considered here is that the taper is set at the rate originally suggested by the Centre for Social Justice report, *Dynamic Benefits*, which first proposed Universal Credit: 55% rather than 65%. This would not be cheap, costing a similar amount to a £1000 increase in the tax allowance. It would, however, make a big difference to families with children on modest but not very low earnings, whose tax credit entitlements would be tapered away considerably less quickly than under the current plan for UC.

Effects on rewards for work

Finally, it is important to note that, as well as giving varying amounts to low to middle income working families, these various policies would also have different impacts on the marginal "rewards from work" – the amount that people keep for each additional £1 earned. Once the UC taper and other direct taxes are taken into account, taxpayers on UC will lose 76p in the pound[11], and so be only 24p better off for each £1 extra in pay. In the policy scenarios above:

- Higher tax allowances would produce a small fall in marginal tax rates for a small proportion of taxpayers. Roughly 200,000 of the 3 million taxpayers in UC families have less than £1000 of taxable income and so would be lifted from tax altogether by a £1,000 increase in the personal allowance. By being taken out of tax (but not National Insurance Contributions), they would be able to keep 29p of each additional pound earned rather than 24p under the current UC proposals.[12]

- Higher disregards would produce a larger fall in marginal deduction rates for the relatively small minority of those receiving UC whose earnings take them just above the present disregard. This would only occur where a single earner was doing a part-time job for very low pay; for example, with a £1000 increase in disregards, a single parent on the minimum wage would be able to work 13 rather than 10 hours before hitting the income taper. When increasing hours within that narrow range, the single parent in this example would keep all their UC, rather than having it reduced by 65% of the increase in earnings.[13]

- Higher UC entitlements would also increase effective marginal tax rates for some middle income households. This is because more generous UC payments would bring people into the system whose incomes are too high to receive support in the system as currently designed. Again, they would then become subject to the 76 per cent withdrawal rate referred to above.

- A lower taper rate would have the most widespread impact on overall deduction rates. Most working UC claimants would gain, with non-taxpayers keeping 45p rather than 35p in the pound, and taxpayers keeping 31p rather than 24p of additional income, if the taper rate were lowered from 65 to 55 per cent. However, more people would also be brought into the UC system, raising their marginal deduction rates.

As these work incentive effects make clear, any tax-benefit reform involves unavoidable trade-offs. By definition, the better targeted a policy becomes in helping those on the lowest incomes,

[11] Of each £1 of additional gross income, they lose 20p through basic rate income tax and 12p through employee National Insurance Contributions. Of the 68p remaining, they lose 65p of Universal Credit, equating to 44.2p of every £1 of gross income (0.65 X 0.68 = 0.442). Their final effective tax rate is 20% + 12% + 44.2% = 76.2%

[12] This is because the rate of income tax they pay would fall from 20p to 0p. They would therefore lose 12p of every additional £1 earned through employee NICs, followed by 65 per cent of the remaining 88p of net income (0.65 x 0.88 = 0.57.2). This leaves a marginal tax rate of 71 per cent (12 per cent plus 57.2 per cent).

[13] It is important to note that a higher disregard would also increase the number of people entitled to UC, by causing the entitlement to extend to those on higher income levels. Additional recipients would get extra support they would also face higher income withdrawal rates than before, keeping only 24p in the pound rather than 68p.

the more it implies a sharp fall-off in support as income rises. As a consequence, there is no single most efficient way of helping low to middle income households: concentrating help on those who need it the most also produces high withdrawal rates.

Conclusion

As thoughts turn to the next general election, all parties are likely to set out some tax cutting plans for the next parliament. Already plans have been mooted for further increases in the personal allowance or for the re-introduction of a starting 10p rate of tax. Whatever one makes of these proposals it is important to appreciate that, as things stand, the government's flagship welfare reform, Universal Credit, conflicts with these plans in terms of the help they will give low to middle income families. Because UC will operate on the basis of post-tax income, the vast majority – 65 per cent in most cases – of the benefits of any tax cut for UC claimants are returned immediately to the government in the form of lower UC support.

Fixing this problem requires that UC be adjusted by raising disregards each time the personal allowance is raised, or when a 10p tax band is introduced. To make sure low to middle income working households receive the full benefits of a tax cut, UC disregards would need to be raised by 20% of any increase in the personal allowance and by 10% of the width of any new 10p tax band. Any party proposing tax cuts that does not adopt this or an equivalent policy cannot claim to be helping low to middle income households by cutting taxes. This approach would of course make any tax cut more expensive. But it would also prevent tax cuts from benefiting only better off families.

This briefing note has also stepped back to look at the relative effectiveness of different forms of support for these households. It has shown that in boosting the position of working families on low to middle incomes, measures to improve Universal Credit provide far better value for money than reducing income tax through higher allowances or the introduction of a new starting-rate band. For example, raising the income level at which UC starts to be reduced (the "disregard") could benefit a low to middle income working family on UC by around 15 times as much as an increase in the personal tax allowance costing the Exchequer the same amount.

To be clear, our conclusions do not mean that improvements in UC should always be preferred to tax cuts. Too much reliance on means-tested transfers to working families can stifle incentives to raise earnings by working longer hours, seeking training or negotiating wage increases. However, at a minimum, it is clear that future tax cuts will need to run alongside reforms to UC to make sure the families who are struggling the most receive as much benefit as everyone else.

The Resolution Foundation

The Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged. We do this by:

- undertaking research and economic analysis to understand the challenges facing people on a low to middle income;
- developing practical and effective policy proposals; and
- engaging with policy makers and stakeholders to influence decision-making and bring about change.

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