Missing the target

Tax cuts and low to middle income Britain

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Summary

This report has two main objectives. First, to assess the main political parties’ leading proposals on tax cuts for the next Parliament. Second, to consider whether there is a different approach to that advocated by the main parties that would better serve low and middle income Britain.

» Over the course of this Parliament, huge priority has been given to raising the income tax threshold, ostensibly – in the face of declining living standards – to help workers on low pay and low to middle income households more generally, with much being made of the number of people ‘taken out of tax’. The coalition has increased the personal allowance from £6,475 in 2010-11 to £10,500 in 2015-16.

» Despite the highly challenging fiscal environment, the four main parties have proposed further income tax cuts for the next Parliament: a £12,500 allowance by 2020 from the Conservatives and Liberal Democrats, a £13,500 allowance from UKIP, and a much more limited re-introduction of a 10p tax band in Labour’s case. Each of these policies is poorly targeted on low and middle income households: the clear majority of the gains go to the top half of the distribution in all instances. In addition, the Conservatives have pledged to raise the higher rate threshold to £50,000 and UKIP to create a new 35p tax band on incomes between around £47,000 and £61,000 (based on a desire to initially introduce a band between £42,285 and £55,000 in 2015-16). These additional measures are highly regressive.

» Taken together, the parties’ proposals result in between a third (Labour and Liberal Democrats) and approaching a half (UKIP and the Conservatives) of the overall gains flowing to the richest 20 per cent of households. In all instances, no more than one-quarter of the cost of the plan is accounted for by the entire bottom half of the income distribution. Crucially, this analysis ignores the potential distributional effects associated with raising the funds necessary to deliver on these promises: the distribution of gains is likely to be amplified or mitigated depending on the approach taken.

» Despite the stated focus on helping low earners and struggling households, none of the parties’ proposed tax cut policies are of any benefit to the
nearly five million lowest paid employees who pay no income tax. Within this group, an estimated 1.2 million will be paying employee National Insurance from April 2015 (expected to start at just over £8,000) but will be earning too little to pay income tax. Under the proposed increases in the personal allowance in the next Parliament their number would swell to between 1.6 million (Conservative and Liberal Democrat policies) and 2.1 million or more (UKIP). None of these low-earning ‘taxpayers’ will receive any gain from the proposals of the four main parties.

In contrast to the focus on tax cuts, the parties have given little attention to the role that in-work benefits can play in supporting those on low and middle income households in the next Parliament. Over 10 million individuals and more than 4 million working families will be eligible for the new Universal Credit – which all parties have committed to introducing. Yet little has so far been said in this area.

Within Universal Credit, the ‘work allowance’ serves a similar role to personal tax allowances: below the allowance, recipients keep all their earnings from work; above it, awards will be rapidly withdrawn at a taper rate (in effect a tax rate) of 65 per cent. In contrast to the personal allowance, the generosity of the work allowance has been cut over the course of this Parliament (with further cuts planned).

If we really want to help working families on low and middle incomes, boosting the work allowance would be more effective, and better value for money, than any tax cuts. For example, a £1,000 increase in the work allowance available to a single parent earning £12,000 would boost their income by £650 a year. In contrast, a £1,000 increase in the personal allowance would benefit them by just £70.

The parties’ current focus on income tax is even harder to rationalise given that the design of Universal Credit collides with tax cuts. Because the 65 per cent taper is applied to a household’s net income, two-thirds of the intended gains from any tax reductions will automatically bypass all households eligible for Universal Credit. That is, every £1 gain associated with a tax cut results in a 65p reduction in their Universal Credit entitlement.
» We favour a different approach – fully funded tax and benefit reform that is genuinely geared towards low and middle income households:

» Prioritise improvements in the Universal Credit work allowance above all else. This is the most targeted and cost-effective way of supporting millions of struggling working households.

» Adjust Universal Credit so it is tax-cut friendly. Without this, tax cuts will largely bypass several million hard-pressed working people.

» Raise the National Insurance threshold in real terms over time so it aligns with the personal allowance, prioritising this over any further hikes in the latter. This would rectify existing anomalies, simplify the system and be less regressive than increasing the personal allowance. Because National Insurance is only payable on earned income and by those of working-age, it would restrict gains to this group who have done less well than retired households over this Parliament.

» Combining these approaches would provide a big boost to low and middle income households. The biggest winners would be in the bottom half of the income distribution, among families with children and those of working-age. This contrasts markedly with the proposals of all the main political parties.

» We don’t propose these measures should be paid for via yet deeper unspecified cuts. Nor do we want to rely on populist taxes that may fail to raise the desired revenue. Instead we propose a package of revenue sources: a three-year freeze in the personal allowance, a two-year freeze in the basic rate limit (and, by implication, the higher rate threshold) and the introduction of National Insurance payments for those working above the state pension age. Losses associated with these policies would be more than offset for the great majority of households by the combined gains flowing from raising work allowances and increasing the National Insurance threshold.
» In the event that the economy grew more quickly than expected and the fiscal situation therefore improved more rapidly than we would expect, an alternative package could be introduced that was less reliant on an offsetting freeze in the personal allowance. Equally, if the economy instead fared less well than is currently supposed, then a worse than expected fiscal situation may mean that it is judged to be the wrong time to be considering any form of tax cut or increase in benefit spending – even a fully self-funding one such as the package we set out.
Section 1: Introduction

Introduction

Our tax and welfare systems play a crucial role in society. They determine how we pay for public services, make distributional choices (between rich and poor, times of life, across generations and groups with high needs), tackle poverty and insure ourselves collectively against risks. In theory they do this while trying to avoid harming – or even seeking to improve – the incentive to work and get on.

This short paper – the first in a series of pre-election papers on different policy areas – assesses how all the major parties are performing in terms of their stated positions on reforming the tax system to help those on low and middle incomes. It suggests an alternative agenda to that being proposed by any of the main parties.

First a word about context. Most obviously, current discussions about tax cuts take place in the shadow of six years of falling real pay and falling or flat living standards. The political pressure to offer hard-pressed households some relief is, to a degree, therefore understandable. Pay levels, by and large, aren’t under the direct control of government. Tax rates and thresholds typically are.

But, and much less congruently, the debate on ‘tax cuts’ is also taking place against the backdrop of an unprecedented period of ongoing fiscal austerity. Approximately half of the planned fiscal consolidation will have been achieved by the end of this Parliament, with the other half pencilled in for the next one. The different parties’ plans for achieving further consolidation can at best be described as ‘sketchy’.

Indeed it is striking that, given the formidable amount of fiscal tightening still to come, no party is clearly talking about net tax rises. Instead all are, to varying degrees, focused on tax cuts. This is all the more noteworthy, as this report highlights, given that in reality the main beneficiaries of these proposals tend not to be the groups that the tax cuts are purportedly designed to reach, and some of the proposals are not funded via offsetting measures.

In adding to this debate, this report is deliberately narrow in its scope. Some important caveats are therefore needed.

» Most of the big drivers of living standards – such as pay and productivity – lie outside of its scope (and are looked at in other Resolution Foundation work instead). Our specific focus here is the far narrower question of how the tax and benefit system could be used to improve the incomes and incentives of working households.

» It’s also the case that we only look at some aspects of the tax and welfare system. We don’t consider wider changes in indirect taxes such as VAT or indeed taxes on corporations or wealth (like inheritance tax or property taxes). Instead we focus on specific aspects of the personal tax system: the personal tax allowance; the employee National Insurance threshold; proposals for new income tax bands; and the interaction of the tax system with the benefit system in the form of the new Universal Credit.

[1] It is important to note that under the new proposals of the Smith Commission there will be important reforms relating to the power of the Scottish Parliament to vary income tax rates and thresholds – though not the personal tax allowance.

Section 1: Introduction

We don’t seek to assess the claims made by the different parties over how they will pay for their proposals (to the extent that they specify this). Nor is it an overall assessment of all their spending and tax plans and their distributional implications. We focus narrowly on their headline personal tax proposals and who benefits from them.

The proposals set out here are highly stylised and broad-brush. For instance, we only consider one reform to Universal Credit to contrast this with the impact of tax cuts. However, wider challenges and potential changes to Universal Credit extend far beyond this (and are looked at in a wider Resolution Foundation project). Similarly, we propose one possible way of funding a tax reform package. There are plenty of other options that could be chosen. Our primary point on funding is that we don’t favour proposing net tax cuts now to be funded at some later point out of even more punitive spending cuts or as yet unspecified tax rises.

Section 2

Supporting working households: the evolution of taxes and in-work benefits over the current Parliament

Since the onset of the financial crisis, households have faced a number of challenges that have borne down on their living standards. While the employment rate has recovered strongly in recent months, real earnings continue to fall – meaning the pay squeeze is now six years old. Unable to directly influence labour market outcomes, the Coalition government has argued that it has instead sought to support hard-pressed families by cutting income tax. Yet these tax cuts have only applied for those with incomes – earned and unearned – above the personal allowance. Increasing numbers of lower paid workers have failed to share in the gains. In addition, the government has simultaneously reduced the generosity of in-work support available through tax credits.

Tax cuts in tough times: raising the personal allowance

Faced with a large budget deficit when it came to power, the Coalition government has implemented a wide range of spending cuts over the course of its time in government. It has reduced expenditure as a share of GDP from a peak of 47 per cent in 2009-10 to an estimated 43 per cent in the current financial year. Based on the Coalition’s published plans, the OBR has projected that the cyclically-adjusted current budget will return to balance in 2017-18, by which time government spending will account for 39 per cent of GDP.

Alongside these cuts – focused on both reductions in departmental spending and reductions in the welfare budget – the government has raised significant revenues from a variety of tax increases, including on VAT, National Insurance (NI) and the implementation of the additional rate of income tax (initially 50p, now 45p). Yet, much of the revenue raised via these tax increases has been used to fund a policy of increasing the personal tax allowance at a faster pace than is usual – effectively delivering a series of tax cuts to basic and (more often than not) higher rate taxpayers.

Having inherited a personal allowance of around £6,500, the Coalition has matched the pre-election Liberal Democrat pledge to raise the point at which employees begin to pay income tax to £10,000, at a cost of around £11 billion.\[5\] It is set to rise to £10,500 from April 2015. The policy has been labelled as one designed to take the lowest paid out of income tax entirely – nearly five million employees now pay no income tax – as well as offering help to low and middle income households more widely amid a period of declining living standards.

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[4] When the Coalition came to government, the default for uprating the personal allowance was RPI inflation; the government has since changed this default to (the usually lower) CPI inflation.

A very different approach has been taken to NI. In 2011, the employee NI threshold was also increased substantially, to mitigate the impact on households of a revenue-raising increase in the main NI rates (from 11p and 1p to 12p and 2p). Thereafter, it was uprated in line with CPI inflation. Coalition policy changes have resulted in a widening gap between the point at which individuals start paying NI (at 12 per cent) and the point at which they start paying income tax (at 20 per cent). Interestingly, this growing gap has emerged at the same time as there has been greater political interest in integrating the NI and income tax systems.

As Figure 1 shows, by April 2015 the NI-income tax gap is expected to stand at close to £2,500. So, while the number of employees who are no longer liable for either tax – income tax or NI – has increased over the course of the parliament (from 2.1 million to 3.5 million), so too has the number who pay no income tax, but do remain liable for NI (from 0.4 million to 1.2 million). These 1.2 million NI-only payers are regularly overlooked when it is asserted that five million workers ‘pay no tax’.\[6\]

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Figure 1:

Employees earning less than personal allowance and/or employee NI threshold

Pay employee NI but not income tax

Pay no employee NI nor income tax

Personal Allowance

Employee NI

Notes: Numbers of people earning less than relevant thresholds are estimates based on employees only, though their tax liability is calculated with reference to all forms of taxable income. The figures exclude the self-employed. It also excludes those not in employment. From 2013-14 onwards, we estimate employee numbers and wage growth with reference to projections in the Bank of England’s Inflation Report from November 2014.

Sources: RF analysis of DWP, Family Resources Survey

[6] And of course, even the 3.5 million who pay no income tax or NI continue to pay plenty of other forms of tax such as VAT.

This publication is available in the Welfare & Tax Reform section of our website @resfoundation
Reducing in-work support: tax credit cuts

While the gains associated with these tax cuts have undoubtedly helped workers struggling in the face of falling real-terms pay, many families have simultaneously faced major reductions in their access to the in-work support provided by tax credits. In addition to changes in eligibility and the rate at which support is withdrawn as a household’s earned income rises, the generosity of tax credits has been eroded by a series of real-terms cuts in the support provided. By the end of the current financial year, tax credit reforms implemented since 2010 are estimated to have saved the government in the region of £5 billion. Those in work are obviously also affected by real term cuts to a range of other benefits like Child Benefit that we don’t consider here.

Choices made in relation to tax credits, and indeed the new system of Universal Credit (see Box 1), have a very direct impact on the living standards, and work incentives, of millions of working households. Often little reported and technical sounding changes in tax credits will be of far greater import for family budgets than headline grabbing changes in taxes.

By way of illustration, consider the example in Figure 2. An increase in the work allowance in UC of £1,000 would boost the net income for someone earning £12,000 by £650 a year. In contrast, a £1,000 increase in the personal tax allowance would raise their net income by just £70. The individual in this example would only begin to gain more from the personal allowance increase than from the work allowance increase once their gross earnings topped £29,000.

Box 1. Universal Credit and the ‘work allowance’

The tax credit system is due to be replaced over the course of the next parliament by Universal Credit (UC). This new, combined payment will replace six existing working-age benefits, providing – it is hoped – a more straightforward transition between unemployment and work.

One of the key features underlying this transition is the creation of a ‘work allowance’ for UC recipients. This is the amount a household can earn before any of their UC entitlement starts to be withdrawn. In this sense, it has parallels to income tax and NI thresholds, though the size of the allowance varies depending on household size and circumstances. Once the work allowance is reached, a household has its UC withdrawn at the rate of at least 65 per cent of its net income.

UC’s 65 per cent taper is designed to be simpler than the current system in which varying forms of state support are withdrawn at differing rates as household earnings rise. It is also expected to reduce the number of households facing extremely high marginal deduction rates (MDRs). However, in practice the 65 per cent net income taper will interact with income tax and NI to produce MDRs of between 65 per cent and 76 per cent depending on the family type (i.e. the size of the work allowance) and the level of gross earnings (i.e. the income tax and NI faced by individuals in the household). It may be simpler than the status quo, but it’s still complicated.

To illustrate how much these arrangements matter, Figure 2 takes the specific example of a single parent with one child and housing cost support that amounts to £6,000 a year. In total, their out-of-work UC entitlement would stand at around £12,350. Initially, the single parent gets to keep all of their earned income with no reduction in their UC award but, once their earnings surpass £3,156 (the point at which their work allowance is exhausted), their UC entitlement is withdrawn at the rate of 65p for every additional £1. After their earnings reach around £8,000, they also become liable for NI. At this point, their MDR rises to 69p in the £1.

Once their income tops £10,500, they must start paying income tax as well and now face an overall marginal deduction rate of 76 per cent. For this individual, all of their UC entitlement disappears by the time their gross earnings reach £28,080, at which point they face a ‘normal’ effective tax rate of 32 per cent.

1 That is, the 65 UC taper now applies to net income that is subject to a 12 per cent deduction rate.

2 That is, 12 per cent NI plus 20 per cent income tax.

[7] This total relates to savings, estimated at the time of policy announcements, associated with direct changes in awards and eligibility. It excludes administrative savings. OBR, Policy measures database.
Figure 2: Example budget schedule and marginal deduction rates for single parent with housing costs: 2015-16

Notes: Individual is assumed to have one child and receives £6,000 towards their housing costs. For simplicity, marginal deductions associated with the withdrawal of Council Tax Support and the cost of childcare are not included in this chart.

Sources: Resolution Foundation

The example brings home both the importance of UC to the disposable income of many struggling households, as well as the blunting of the incentive to work that withdrawal of that support at 65 per cent can provide. It also highlights the fact that the impact of a given tax cut is eroded by the design of UC – with each £1 tax-cut resulting in 65p of UC being removed.
Section 3

More of the same: the parties’ pledges for tax cuts and in-work benefits in the next Parliament

Each of the four main parties seem keen to appear to be helping in-work low and middle income households in the run-up to next year’s election. But – as with the Coalition’s approach to date – they are all focusing on income tax rather than NI, tax credits or UC. They have all pledged to deliver some form of income tax cut, but are mainly silent on the issue of in-work support. The announcement that has been made to date proposes a reduction in generosity, in the form of the Chancellor’s pledge to freeze the value of tax credits (and a number of other working-age benefits) for the first two years of the next Parliament. To date then, none of the parties appear to be offering tax and benefit reform packages that genuinely help those on low to middle incomes.

The parties’ promises on income tax cuts

Both the Liberal Democrats and the Conservatives have promised to raise the personal allowance to £12,500 by April 2020. UKIP have gone further still, pledging to increase the allowance to £13,500.

In interpreting these commitments, it is important to bear in mind that inflation will of course reduce the cost (and the impact) of these proposals. Even with no policy interventions the personal allowance under current inflation projections might be expected to reach around £11,600 by 2020-21. Indeed, the allowance would have been expected to stand at around £9,200 by April 2020 if the default uprating that was in place in 2010 (namely, RPI inflation) had been maintained – that is without any of the Coalition’s policy changes.

Given expected levels of inflation, the new pledges on the personal allowance will come with sizeable price tags. The Conservative and Liberal Democrat policy on the personal allowance will cost in the region of £5 billion, while the UKIP pledge would cost around £10 billion.[8]

It’s also important to note that, as the personal allowance increases in real-terms, so the profile of the winners changes. In recent years, the age-related personal allowance for those above pension age has been fixed (at £10,500 for younger pensioners and at £10,660 for older pensioners), meaning that they have not shared in any of the gains associated with raising the level of the working-age allowance this Parliament. But, once the main allowance reaches £10,500 in April 2015, somewhere in the region of six million pensioners will be included among those who benefit from further above-inflation gains.

Alongside going further on the personal allowance, there are also other tax cuts on offer. The Conservatives have promised to raise the point at which the higher rate of tax is paid, while UKIP have called for the introduction of a new 35 per cent tax rate. Labour have similarly argued for a new tax rate – but this time at the lower end – with the reintroduction of a narrow 10 per cent band above the personal allowance. We consider each party’s proposals in turn below.

[8] Of course, if inflation undershoots over the next few years then these commitments become more ambitious (and far more expensive to the exchequer).
But before doing so it is important to highlight that in the following section we are looking purely at the ‘winners’ of these policies. The distributional charts take no account of the ‘losers’ – not least as in several cases it is unclear yet who they will be.

**Liberal Democrats: taking the personal allowance to £12,500**

The Liberal Democrats have committed to raising the allowance to £11,000 in April 2016, before reaching £12,500 by April 2020. They have no plans to withdraw gains from higher rate payers, meaning that all who currently earn between £10,500 and £121,000 would receive the same benefit.

The Liberal Democrats have stated that they will fund the move via other forms of (only-partially specified) tax increases on the wealthiest. They will also remove the marriage tax allowance introduced by the Coalition government from April 2015.

Additionally, they have floated the aspiration of raising the employee NI threshold to the level of the personal allowance once the £12,500 goal has been reached, but there is no proposed timetable or funding for this. Given that the gap between the NI threshold and the personal allowance would stand at over £3,600 by the time the allowance reaches £12,500, such a policy is going to be very expensive. To give a sense of the scale of this commitment, if it were to be introduced in 2020 it would cost the Liberal Democrats an extra £9 billion.

**Figure 3:**
Distribution of gains across households under the Liberal Democrat proposal to raise the personal allowance to £12,500 by 2020-21

<table>
<thead>
<tr>
<th>Change in average income (annual)</th>
<th>Percentage change in income</th>
</tr>
</thead>
<tbody>
<tr>
<td>£0</td>
<td>0.0%</td>
</tr>
<tr>
<td>£18</td>
<td>0.1%</td>
</tr>
<tr>
<td>£39</td>
<td>0.2%</td>
</tr>
<tr>
<td>£78</td>
<td>0.3%</td>
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<tr>
<td>£112</td>
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</tr>
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<td>£152</td>
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</tr>
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<td>£202</td>
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<tr>
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<tr>
<td>£273</td>
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</tr>
<tr>
<td>£287</td>
<td>0.5%</td>
</tr>
<tr>
<td>£203</td>
<td>0.4%</td>
</tr>
</tbody>
</table>

Source: Analysis considers the impact of raising the personal allowance to £12,500 in April 2020 alongside removing the marriage tax allowance.

Source: Resolution Foundation analysis using the IPPR tax-benefit model
The logic of this tax-cut sequencing can be questioned. It seems to be to reduce taxes for everyone in the country earning between £10,500 and £121,000 before, at some later date, turning to help those earning as little as £8,000. However, it should also be pointed out that they are the only party to even have raised the issue of the NI threshold: Labour, Conservatives and UKIP have been silent on the issue.

As we will see in relation to all the parties’ plans, those already below the personal allowance (including those taken out of income tax over the course of the current parliament) don’t gain at all. Similarly, those set to be taken out of income tax over the course of the next parliament by the above inflation increases in the allowance only receive part of the tax cut. Again a common distributional issue faced by all the parties is that, at a household level, two earner families tend to be richer and gain twice over from income tax cuts, while single earners – regardless of family size – gain only once.

As we will see in relation to all the parties’ plans, those already below the personal allowance (including those taken out of income tax over the course of the current parliament) don’t gain at all.

Conservatives: raising the personal allowance and the higher rate threshold

While the Conservatives have made the same headline pledge to raise the personal allowance to £12,500 by 2020-21, their approach to income tax differs in an important respect. They have simultaneously promised to raise the higher rate threshold – the point at which people become liable for 40 per cent income tax – to £50,000 over the same timeframe. This move is an attempt to reverse the steady increase in the number of taxpayers in this band in recent years, which has been driven both by fiscal drag and by past real-terms reductions in the threshold (designed to offset some of the gains for higher rate taxpayers associated with raising the personal allowance).

In total, the two Conservative proposals are estimated to cost £7.2 billion, with the required funds to be raised from further as yet unspecified spending cuts. These cuts are on top of a promised £12 billion of new cuts to the welfare bill and an estimated £25 billion of additional cuts to departmental spending (not counting the £8.5 billion of cuts in 2015-16 to which all parties have committed).

As Figure 4 shows, the inclusion of an increase in the higher rate threshold means that the Conservative approach would prove more regressive than the Liberal Democrat one. The peak gain (in proportional terms) occurs in the ninth decile of the income distribution. Low to middle income households fare much less well.

[9] Conservative HMT figures, replicated by Resolution Foundation

UKIP: hike in the personal allowance and a new 35p tax band

As with the Conservatives, UKIP have sought to link their personal tax allowance policy to the salary of someone on the minimum wage. The Conservative personal allowance target of £12,500 is linked to an estimate of the earnings that would be associated with working 30 hours at the National Minimum Wage (NMW) in April 2020 (implying a wage of around £8 an hour). UKIP have instead selected £13,500, on the basis that this would equate to full-time minimum wage earnings.

If we assume UKIP mean to reach a personal allowance at this level by 2020 it costs roughly £10 billion, double the Conservative/Liberal Democrat policy. It is important to note, however, that this is quite possibly a very low estimate of the cost of the UKIP proposal. Rather than attaining a personal allowance of £13,500 in 2020 it is possibly more in tune with the spirit of their stated policy to assume that they intend the personal allowance to rise to £13,500 in 2015-16 and then for it to rise in line with the growth in the NMW over the next Parliament (otherwise they would be failing in their objective to remove a full-time worker on the minimum wage from income tax).
This would, however, dramatically increase the cost. [11]

Alongside the increase in the personal allowance, UKIP have also pledged to introduce a new income tax band of 35 per cent on earnings between £42,285 and £55,000 (whereupon the 40 per cent higher rate of tax becomes payable). [12] Together, their two income tax pledges (as we interpret them) amount to an estimated minimum cost of around £13 billion. In addition to this there is a commitment to abolish inheritance tax (with an assumed cost of around £6 billion) that we don't model here as we are focussing on income tax. [13]

Figure 5:
Distribution of gains across households under UKIP proposal to raise the personal allowance to £13,500 and introduce a 35p rate of tax above the current higher rate threshold by 2020-21

Notes: Analysis considers the impact of raising the personal allowance to £13,500 in April 2020 alongside introducing a 35p tax band between £47,000 and £61,000. 
Sources: RF analysis using the IPPR tax-benefit model

[11] The stated policy suggests that the personal allowance should be sufficient to ensure that no one working full-time on the NMW would be liable for income tax, which UKIP argue implies a level of £13,500 by the time of the next election. Given the NMW currently stands at £6.50, this implies that UKIP are taking “full-time” to equate to 40 hours. If the NMW moved in line with projections for average earnings, it would rise to around £7.70 by April 2020. Using the same 40 hour definition of “full-time” would imply a personal allowance in the region of £16,000. Key unknowns relate to the level of the minimum wage in 2020 and quite what it meant by ‘full-time’. On this basis however, the personal allowance policy is estimated to cost around £22 billion, or £25 billion when combined with the 35p rate.

[12] Given that £42,285 corresponds to the higher rate threshold in April 2015, we assume that UKIP intend to introduce the 35p band immediately at the given levels. If these upper and lower bounds subsequently rose with inflation, they would reach around £47,000 and £61,000 respectively by April 2020. These are the figures we assume in modelling their policy.

The personal allowance policy produces a similar distributional pattern of winners to those shown for the Conservatives and the Liberal Democrats, though clearly the gains – which are concentrated towards the top of the income distribution – are larger. The addition of the 35p tax band adds to the regressive nature of the policy, by providing a tax cut exclusively to those earning above £47,000 (that is, £42,285 uprated with inflation through to April 2020).

Figure 5 on the previous page sets out the distribution of gains under this combination and shows that the biggest winners (proportionately) are found in the eighth decile.

Labour: re-introducing the 10p starting rate of tax

By way of comparison the Labour party has made far less extensive – and therefore much less expensive – proposals for tax cuts in the next parliament than the other parties. It has, however, committed to re-introducing the 10p tax band for non-savings income, but has not yet specified how wide the new band would be.

Based on policy statements it seems that Labour is planning to recycle around £800 million of savings from scrapping the marriage tax allowance to pay for the 10p rate. This approach has the merits of being fully funded – but would imply a new 10p band on a stretch of income as small as

Figure 6:
Distribution of gains across households under Labour proposal to re-introduce a 10p starting rate of income tax for the first £340 above the personal allowance in 2020-21

<table>
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<th>Change in average income (annual)</th>
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</table>

Notes: Analysis considers the impact of re-introducing a 10p rate of income tax across the first £340 of taxable income (£300 in 2016, rising thereafter with inflation. As with the Lib Dem proposal, the marriage tax allowance is removed).

Sources: RF analysis using the IPPR tax-benefit model
£300 in April 2016. This extremely narrow range for a proposed tax-band must raise questions over whether such a small-scale reform would actually be implemented. Alternatively, Labour might choose to find more resources to fund a 10p band covering a larger stretch of income.

For the purposes of this note, we model the impact of this measure in 2020–21, by which time it would cost £900 million. Figure 6 sets out the distributional impact and shows that it is very similar in shape to the Liberal Democrats’ personal allowance proposal, but that the cash gains involved are, obviously, much smaller. Once again, the gain is concentrated in the upper half of the income distribution (with the biggest proportional gains coming in the seventh decile). [14]

Figure 7 compares the distributional gains associated with each of the four party policies set out above. It shows that the UKIP approach would cost far more than any other and involve a much larger giveaway. At the other end of the spectrum, Labour’s policy would have relatively little cost but would also have very little impact on households. Across all parties the share of gains going to the bottom half of the income distribution is limited. While Conservative and UKIP proposals are the most regressive, the Liberal Democrat and Labour approaches also result in households in the top half experiencing the biggest gains. Despite their claims, no political party is offering tax cuts targeted at low and middle income households.

Figure 7: Who really gains from each party’s proposed tax cuts?

Notes: All figures are modelled for 2020-21. Conservative proposal raises the personal allowance to £12,500 and the higher rate threshold to £50,000. Liberal Democrat proposal raises the personal allowance to £12,500. UKIP proposal raises the personal allowance to £13,500 and introduces a 35p tax band between £47,000 and £61,000. Labour proposal re-introduces the 10p starting rate of income tax on the first £340 of income above the personal allowance. Labour and Liberal Democrat approaches are modelled in the absence of the marriage tax allowance.

Sources: RF analysis using IPPR tax benefit model

[14] It is important to note that as we are focusing on tax-cuts here this doesn’t take account of Labour’s proposal to increase the additional rate to 50p. This will impact on the position of a small number of the very highest earners.
As another way of looking at this, Figure 8 shows how each £1 of the planned tax cuts set out above would be shared across the income distribution. Under all parties the top half do well. It shows that, even under the less regressive Liberal Democrat and Labour approaches, no more than one-quarter (25 per cent and 24 per cent respectively) of the overall cost is accounted for by households in the bottom half of the income distribution. Under the Conservatives (18 per cent) and UKIP (19 per cent) it is lower still.

Approaching half of the costs of the Conservative (46 per cent) and UKIP (43 per cent) proposals are accounted for by households in the top one-fifth of the distribution. Among Labour (34 per cent) and the Liberal Democrats (31 per cent) the top fifth account for one-third of the cost.

Again, it is worth noting that the distributional consequences will be amplified or mitigated depending on how the parties fund their approaches.

**Figure 8:**
The distribution of gains under each party’s proposed tax cuts in 2020-21

**Notes:** Distribution of gains per £1 spent on the different proposals as modelled in 2020-21. This analysis ignores the fact that the parties are proposing different-sized giveaways and that finding the funds for these measures is likely to involve further distributional choices. See notes to Figure 7.

**Sources:** RF analysis using IPPR tax benefit model
The reduced relevance of tax cuts to UC recipients

The distributional impact of each of the parties’ tax cut proposals is not helped by the fact that there is currently an unfortunate, and little understood, interaction between UC and tax cuts. Because UC is withdrawn as net household income increases, an income tax or NI cut that boosts a household’s net income by £100 would automatically mean a £65 withdrawal of UC. Low and middle income working families on UC will therefore only receive around one-third of the gains flowing to better off households.\[^{15}\]

As Donald Hirsch set out for the Resolution Foundation, this is a new problem, directly linked to the design of UC.\[^{16}\] The withdrawal of existing benefits and tax credits is largely based on pre-tax income, meaning a similar interaction does not exist. UC will therefore fundamentally change the distributional impact of cuts and increases in income tax or NI.

\[^{15}\] And potentially less if they are also on the Council Tax Support taper.

\[^{16}\] D Hirsch, Will future tax cuts reach struggling working households?, Resolution Foundation, April 2013
Section 4

A better way: targeted support for low to middle income households

What is clear from the analysis above is that, whichever party we look at, so-called tax cuts for ‘low and middle’ income households promised by politicians of all persuasions in the run-up to the election are actually better characterised as tax cuts for ‘middle and high’ income households. Clearly there is a legitimate question about the merits of any tax cuts at a time of prolonged austerity. But, to the extent that some form of support for low to middle income households is considered an important supplement to living standards and other offsetting taxes can be raised, better options are available.

Alternative approaches to taxes and benefits

In this section we consider two alternative approaches. First we consider an increase in the work allowances in Universal Credit, thereby allowing low earning recipients to retain more of their income as they enter into – and progress at – work. As well as boosting incomes further down the distribution, this approach is likely to have positive impacts on work incentives and be more cost-effective. This would be our first priority.

Secondly, to the extent that a future government would want to offer some support across the wider working population as well, we consider raising the NI threshold so it aligns with the personal allowance over time rather than pursuing real-terms increases in the personal allowance. This approach has the benefit of removing the anomaly of having 1.2 million ‘forgotten’ employees who are currently subject to NI but not to income tax (a figure that will rise under Conservative, Liberal Democrat and UKIP proposals). It is also less regressive than the current focus on raising the personal allowance, simplifies the tax system and ensures that gains are focused on working-age households (who are liable for NI).

As well as boosting incomes further down the distribution, an increase in the work allowances in Universal Credit is likely to have positive impacts on work incentives and be more cost-effective. This would be our first priority.

We consider how the gains associated with these two proposals are shared across the distribution in a revenue-neutral situation – meaning other taxes must be raised to fully fund the package (which we consider to be the only realistic approach). In addition, and far less realistically, so we can compare on a like-for-like basis with the main parties proposals in terms of pure winners, we show what the gains look like if our measures could be funded over time via growth (i.e. without offsetting tax rises and therefore without losers).
In short, our proposal is to increase work allowances under UC (as the first priority) and if possible to combine this with an alignment over time of the NI threshold with the personal allowance.

**Raising work allowances**

Despite the current negative rhetoric towards working-age welfare spending, it is not realistic to think that direct tax cuts can somehow substitute for in-work benefits and tax credits. Indeed, all parties are in principle committed to continuing with some system of in-work support and, as things stand at least, to achieve this via the move to Universal Credit.

Around eight million UK families – or one in three working-age families – will be eligible for UC when it is fully implemented. We are currently undertaking a wide-ranging expert panel review of UC to propose changes that would make the policy more likely to support people to get into and progress at work.\[17\] In this paper, we focus narrowly on the benefits associated with boosting the size of the current work allowances provided to UC recipients.

As discussed in Section 2, these allowances differ for different family types, being highest for single parents and the disabled – groups that need the largest financial support in order to incentivise a move into work. Relative to raising the tax thresholds, large increases in work allowances are comparatively inexpensive because they are more narrowly targeted on low to middle income households.

Those who earn less than their increased work allowance would see their marginal deduction rate fall from 65 per cent to zero. Those eligible households that earn more than their work allowance would receive a flat cash increase, just as when raising the tax thresholds.\[18\]

In Figure 9 on the following page we present an indicative example of a real increase of one-fifth in the amount families could keep before UC withdrawal.\[19\] It shows that the distribution of gains flowing from increasing work allowances is very different from the one associated with raising the tax allowance. It is focused on the lower and middle part of the distribution, including among some of the poorest working families. This example, presented for illustrative purposes only, would cost £1.2 billion.\[20\]

Notwithstanding the boost to low to middle income households associated with increasing work allowances, we also set out one way of counteracting the anomaly whereby UC recipients find that they immediately lose two-thirds of any gains associated with tax cuts. This can be achieved by ensuring that future tax cuts are coordinated with increases in work allowances.\[21\] For example, a £100 increase in a family’s work allowance would (for those above it), increase their income by £65, meaning that a £100 tax cut matched by a £100 work allowance increase would ensure they felt the full benefit of the former. It is perfectly possible to create this type of agreed policy adjustment to guarantee that UC is adjusted each time there is a direct tax-cut of one form or another to ensure that the gains don’t bypass families who most need them.

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\[18\] There would also be a modest increase in the number of middle income households who would become eligible for small amounts of UC.

\[19\] In practice, we increase the lower levels of work allowances (those available to people in receipt of housing support) by 20 per cent and then apply the same cash increases to the higher levels of work allowances (available to those who don’t receive housing support).

\[20\] While these allowances are per household – unlike those tax thresholds – another policy option, to be explored further in a later paper, would be to introduce a second earner work allowance, to boost work incentives specifically for second earners.

\[21\] D Hirsch, *Will future tax cuts reach struggling working households?*, Resolution Foundation, April 2013. Note, the fact that UC work allowances are provided at a household level whereas direct tax cuts apply to individuals means that this doesn’t work exactly for two earner couples. Such families would continue to do less well than non-UC receiving counterparts. Dual-taxpaying couples are less likely to be on UC however, and the introduction of second earner work allowances could help to overcome this problem.
Section 4: A better way: targeted support for low to middle income households

Aligning the employee NI threshold

As noted in Figure 1, the gap between the personal allowance and the NI primary threshold is expected to stand at close to £2,500 by April 2015, meaning that around 1.2 million low earning employees will be paying one tax but not the other. Under a scenario in which the personal allowance reaches £12,500 by April 2020, the gap would stretch to over £3,600 and we estimate that the number of employees paying NI but not income tax would be 1.6 million.\(^{22}\) UKIP’s policy of raising the allowance to £13,500 would increase this number to at least 2.1 million.

If a future government wants to pursue the policy of ‘removing lower earners from tax’, then shifting the focus towards raising the NI threshold instead of the personal allowance is clearly superior. Using NI as a means of helping low earners also has the advantage that it is more tightly targeted on employees than income tax, with cuts in the latter also benefiting those with unearned income such as from pensions,\(^{23}\) interest, rental income or dividends. Indeed, cutting income

\(^{22}\) We assume that employment and earnings rise in line with Bank of England and OBR projections.

\(^{23}\) This will become an issue once the main allowance reaches £10,500 (from April 2015), bringing it into line with the age-related personal allowance. From that point onwards, around six million pensioners will start to benefit every time the personal allowance is raised above inflation.
tax but not NI increases the tax bias towards ‘uneared’ income. Our view is that it is hard to identify a coherent argument for wanting to cut taxes for those with incomes between £10,500 and £121,000 (in the case of the personal allowance) while not doing so for those earning between around £8,000 and £10,500.

Aligning the NI threshold with the personal allowance would also represent a major simplification of the tax system, as well as making the option of merging NI and income tax easier in the future. This goes well beyond the scope of our paper, but we note there is certainly some virtue in the idea, proposed by various groups (and explored in part by George Osborne). At present we are in the worst of all worlds: we have the complication of a parallel and largely residualised social security contributory system without there being much left of the contributory principle in reality. There are clearly merits in the contributory principle but there is currently little evidence of a move towards reinventing it. Similarly, there is much talk of simplification but little action to promote it. Raising the personal allowance once again while ignoring the NI thresholds makes integration increasingly less likely.

Yet despite these advantages, none of the main parties are talking about NI. It is very welcome therefore that the CBI recently highlighted the issue, proposing a significant rise in the NI threshold to £10,500 over the next Parliament. The CBI doesn’t, however, say how such a measure would be paid for. Given the fiscal situation – and the risk that unfunded commitments rebound on low and middle income households via other cuts – we feel it is important to set out a funded option.

Given the size of the gap between the personal allowance and the NI threshold, aligning them is clearly an expensive policy ambition. On current projections the personal allowance – rising with CPI inflation – is set to reach around £11,600 in April 2020 in the absence of further policy interventions beyond the increase to £10,500 in April 2015. In contrast, the NI threshold would be around £8,900 (£170 per week). Raising the NI threshold to £11,600 would cost in the region of £6.6 billion – less than the Conservatives’ proposed pair of tax policies, and a bit more than the Liberal Democrats’ proposal, but expensive nonetheless.

While we would maintain that this approach would produce a better outcome than proposals to raise the personal allowance, it is also clear that raising the NI threshold on its own will only do so much for either low earners or low to middle income households. The distributional gains are better than for the personal allowance pledge or Labour’s 10p proposal – but only slightly so. Hence we would only want to combine a rising NI threshold with increased work allowances in UC.

Combining both: boosting the work allowance and raising the NI threshold

Combining these two proposals – re-aligning the NI threshold with the personal allowance while at the same time putting more money into increasing the size of UC work allowances – is a package that would provide support geared towards a large swathe of low and middle income Britain.

As we have identified, each of the main parties has their preferred tax cut(s). Some of these, like Labour’s, appear to be funded (though are incredibly modest). Some are partially funded, others not at all. Given the fiscal context, our approach is to look at funded options for our proposals.

[24] And note, raising the employee NI threshold would not affect the build-up of contributory benefit entitlement, which is determined by a separate threshold and does not depend on actually ‘paying in’.

[25] See for example, IFS, Tax by design, September 2011.


[27] Alongside raising the NI threshold for employees, a further policy priority over income tax cuts should be the NI paid on low self-employment incomes. We will explore this option in a future paper. There is also a case for considering cuts to employer NI, which starts at a similar or sometimes identical threshold to employee NI, but this is not explored here.
The package below is a broad outline of one version of our proposals and how they could be paid for. The exact ‘dosage’ and precise revenue streams can of course be debated.

We look at a revenue-neutral package of five measures:

» Boosting the UC work allowances by 20 per cent.
» Freezing the personal allowance at £10,500 for three years after 2015-16.
» Raising the employee NI threshold in real-terms to align with the income tax threshold over the same timeframe. Both would converge just below £11,000 by the end of the next Parliament.
» Freezing the basic rate limit for two years after 2015-16.
» Ending the exemption of those beyond the state pension age from NI on their employment or self-employment income.

The three-year freeze in the personal allowance would raise around £4 billion. This would go a long way towards funding an increase in the NI threshold to the same level. In this instance, alignment would have a net cost of around £1.4 billion. Those earning less than the personal allowance would receive a tax cut of around £250. For earners above the personal allowance, the income tax increase would reduce this to just over £100. The losers from this particular part of the package are therefore instead drawn from those who are liable for income tax but not NI – primarily pensioners and landlords.

Similarly, we end the exemption from NI of those in work who are over state pension age. This is on the basis that it represents an increasingly arbitrary tax-divide in the workforce given the changed employment patterns among older people; and given the contrasting plight of younger and older workers over recent years. Because we are simultaneously raising the point at which NI is paid, this move would have little effect on low earning workers beyond the state pension age.

And we also freeze the basic rate limit for two years. While this does lead to more people paying the higher marginal rate of 40p, it does by definition raise money entirely from relatively high earners, and allow for the majority of workers to be better off. This is a genuinely ‘difficult’ (if temporary) choice with some clearly undesirable consequences. But if we wish to fund our package some such choices need to be made.

The combined impact of this revenue-neutral package is shown in Figure 10. The gains would be focused on the poorer half of households, with the third poorest decile receiving the biggest boost, both in cash terms and as a proportion of income. Only the richest fifth of households would be significantly worse off with the losses concentrated in the top decile.

[28] Compensating lower income pensioners (which we would wish to do) could be achieved via modest adjustments to pension credit.
## Comparing impacts

For those working on low incomes, this funded package is much more beneficial than the policies proposed by each of the political parties, even before accounting for how the latter might be funded.

Figure 11 repeats the approach set out in Figure 8, comparing the distribution of gains across the parties’ proposals on a pound-for-pound basis. In this instance, we include our package which, unlike each of the others, is self-funding. As such, deciles 8, 9 and 10 are absent from the chart as losses among them pay for the gains flowing to the remainder of the distribution.

In total, the bottom half accounts for 82 per cent of the gains on offer in our approach, rather than less than one-quarter as in each of the parties’ proposals.
While we are clear that a funded package is the only realistic option in the current fiscal climate, it remains the case that alternative outcomes could be achieved if there was additional money available. Given the continued uncertainty over the economic and fiscal backdrops that will face the next government, and different paths of deficit reduction that could be opted for, it is just plausible that some action could be taken on boosting the UC work allowances alongside re-aligning the NI threshold and personal allowance in a way that reduces the losses faced higher up the income distribution.

In Table 1 we consider a series of stylised examples of the impact of the various approaches set out by the parties, alongside our own funded suggestion. By way of illustration, we also include an ‘unfunded’ version of our approach – just one of many that could be envisioned – in which the personal allowance could continue to rise in line with inflation over the course of the next parliament. We are not proposing this approach, nor do we think it realistic, we are merely presenting it here as an alternative in order to provide a better comparison with the unfunded party approaches represented here.

The table shows, for example, that:

» A single worker earning £10,000 a year – below the April 2015 personal allowance – would gain nothing under any of the parties’ plans, but would receive £136 from our package because
of the increase in the NI threshold. They would also have the 12 per cent MDR (i.e. the effective marginal tax rate) in place under the parties’ plans removed following our policy changes, thereby increasing their incentive to work more:

- A single parent earning £10,000 who is in receipt of UC would gain even more – £491 – under our proposal, but would again receive nothing under the parties’ approaches. Again our package would result in a reduction in their MDR – from 69 per cent under the parties’ plans to zero in ours.

- Our (funded) package would boost the income of a one-earner couple with kids on £20,000 a year by £415. In contrast, the biggest giveaway offered by any of the parties amounts to £132 (under UKIP), and comes with a much larger price tag.

- We provide a smaller cash boost to a single worker on £30,000 than is implied by the Liberal Democrat, Conservative and UKIP policies, but again at much lower (i.e. zero) cost. In the unfunded package that we provide for illustration, this individual gains more than under the Liberal Democrat or Conservative approaches.

- For a dual-earning couple in which both earn £25,000, we offer larger gains than are provided by Labour and smaller ones than under the other parties’ proposals (though our unfunded example again results in a bigger boost than is available under the Liberal Democrats and Conservatives).

- Finally, a one-earner couple of £80,000 a year loses £298 a year in our package. This contrasts with gains that range from £34 (under Labour) to £1,080 (under UKIP) based on the parties’ promises – though we also show that it is possible to raise incomes even here under our unfunded example.

Clearly these are stylised examples, and any number of other cases could be considered. And it is worth stating again, that our proposals are deliberately broad-brush. There are other ways of providing support under UC and a number of different trajectories and strategies for aligning the NI threshold with the personal allowance. It is apparent, however, that an approach that builds on the principal of prioritising in-work support via UC and which offers tax gains to those earning as little as £8,000 a year provides a much sharper focus on low and middle income households than does one that offers income tax cuts just to those earning above £10,500.
### Table 1: Impacts on family incomes and work incentives of the various proposals in 2020-21

<table>
<thead>
<tr>
<th></th>
<th>RF (funded)</th>
<th>RF (unfunded)</th>
<th>If no change</th>
<th>Labour</th>
<th>Conservative</th>
<th>UKIP</th>
<th>Liberal Democrat</th>
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<td><strong>Change in annual net income (after tax and after benefits)</strong></td>
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<td><strong>£0</strong></td>
<td><strong>£0</strong></td>
<td><strong>£136</strong></td>
<td><strong>£136</strong></td>
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<td>12%</td>
<td>12%</td>
<td>0%</td>
<td>0%</td>
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<tr>
<td>Single parent (£10k), on UC w/out housing costs</td>
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<td>69%</td>
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<tr>
<td>One-earner couple (£20k) with kids, on UC</td>
<td>76%</td>
<td>76%</td>
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<td>Single worker (£30k)</td>
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<tr>
<td><strong>Total cost of the package</strong></td>
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<td><strong>£7bn</strong></td>
<td><strong>£13bn</strong></td>
<td><strong>£1bn</strong></td>
<td><strong>£8bn</strong></td>
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**Note:** See notes to Figure 8 and Figure 10.
Conclusion

It is perhaps not surprising that, given the unprecedented fall in living standards we’ve seen, political parties are tempted to enter an election campaign competing on tax cutting policies. However, with the Coalition only around half way through its proposed programme of fiscal consolidation, and all main parties talking of further deep cuts to come, this would appear to be an odd time for politicians to be competing on giveaways. Fiscal realities suggest that any tax cuts will need to be funded from commensurate tax rises or yet deeper spending cuts, with decisions about where the balance is struck having clear distributional implications.

In this note, we have argued that, to the extent that some parties focus on net tax cuts at a time of fiscal constraint, this is misplaced. We are also clear that the particular strain of tax cut options that are currently being put forward by all parties are misjudged. We don’t favour any of them.

The focus on income tax cuts under each of the approaches means that gains are shared across those who earn between the level of the personal allowance (£10,500 in 2015) and £121,000 (or higher under, Labour, UKIP and Conservative proposals). We can think of no reasonable point of principle for benefitting such individuals but not supporting the nearly five million lowest paid employees who earn less than £10,500. In particular, the omission of the 1.2 million employees who currently pay NI but not income tax from the parties’ focus appears highly anomalous.

More fundamentally, with all of the parties straining to claim that they are acting in order to support working families who have been badly affected by the decline in living standards experienced over the last five years, we believe there is a much better way of targeting help on those in work who are most in need. The generosity of proposed in-work support available through UC has been reduced over the course of this Parliament. To the extent that the parties have discussed the shape of this support in the next Parliament, the focus has been on cutting generosity still further.

As a means of providing genuine financial support to working families and boosting work incentives, we would prioritise increases in the UC work allowances, thereby allowing recipients to earn more before their awards are reduced. Targeting resources on this policy in isolation would provide a more cost effective boost to those on low and middle incomes than any of the parties’ proposals.

If, having focused on this move, appetite remains for helping a broader range of taxpayers, we are clear that raising the NI threshold is clearly superior to further hikes in the personal allowance or, indeed, introducing new bands of income tax.

By combining a focus on the work allowance with a policy of aligning the NI threshold with the personal allowance, we have sketched out a majoritarian package that can be delivered with no additional fiscal cost. It does, however, generate some ‘losers’. Obviously, we’d far rather be in a world where future growth could pay for these measures. Alternative sources of revenue could be considered. Equally, there are other ways of providing support under UC and alignment of NI and the personal allowance rises could be phased over a longer time period. Each alternative would produce its own pattern of winners and losers and would differ in terms of overall cost. Whatever approach is taken, however, we believe that the principle of acting first on Universal Credit rather than income tax cuts is one to which all parties should adhere.
Resolution Foundation

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» 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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