Taxation For The Enabling State

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Editorial Note

John Hills is Professor of Social Policy and Director of CASE at the LSE. This paper was presented at a seminar held at CASE in April 2000 as a memorial to Henry Neuburger, a government and Labour Party economist who died in December 1998. The papers from that seminar, including a shorter version of this one, will be published by the Policy Press in *Making Public Policy for the 21st Century: Social and Economic Essays in Memory of Henry Neuburger*, edited by Neil Fraser and John Hills. The author is particularly grateful to Holly Sutherland for great assistance with the POLIMOD simulation results shown in Figures 11 and 12 and for helpful comments to her, Andrew Glyn, and participants in the seminar at LSE in April 2000 when a draft of the chapter was presented. POLIMOD uses micro-data from the Family Expenditure Survey which are Crown Copyright and are kindly made available by the Office for National Statistics through the Data Archive. The author is grateful to ESRC for support of CASE at LSE, where the chapter was written, and to Jane Dickson and Rebecca Morris for their work on the paper.

Abstract

This paper takes as its starting point Henry Neuburger's injunction that taxation must be seen as a contribution to the maintenance of the welfare state, not as a dead-weight burden. It sets recent developments in the UK tax ratio in the context of changes in public spending, particularly on welfare services, in the public sector's balance sheet, and the distributional effects of both tax and spending. It then discusses tax and transfer policy since the change of governance in May 1997 in the context of public attitudes to inequality and different forms of redistribution. It compares the distributional effects of the four Labour Budgets since July 1997 with those which would have resulted from simply indexing the April 1997 tax and social security system for income growth. This suggests that actual reforms will on average deliver as much to lower income groups as income indexation would have done, but at lower cost to the public finances, and in a way which is more consistent with public attitudes. However, delays between Budget announcements and implementation meant that inequality and relative poverty increased in Labour's first two years in office. If further progress is to be made towards the target of abolishing child poverty in a generation, the measures so far announced will have to be added to each year.

In economic management and in politics, there is little escape from the discussion of tax. Tax revenue has represented between one third and two-fifths of total national income over the last twenty years, so its scale and design has major effects on the economy. Decisions on how much tax should be levied on different kinds of activity or individuals is one of the central decisions of British politics – hardly surprising with £10,000 to be raised every second. But much of this discussion treats tax as if it was simply a loss to those who pay it and to the economy as a whole, rather than as a vital mechanism to ensure that collective aims can be met and for ends which the market would fail to achieve. As Henry Neuburger put it in a paper for the Fabian Society Taxation Review,

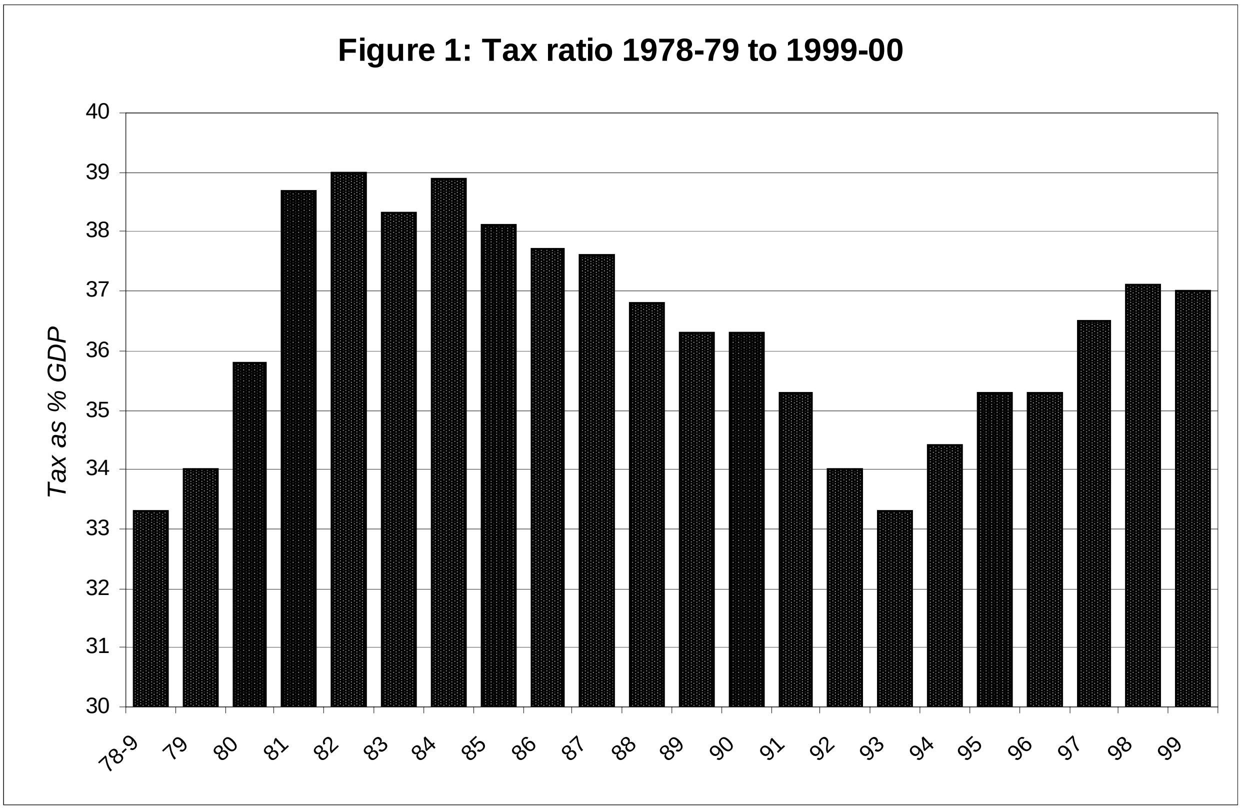
> '... we have to promote the idea of tax as a contribution to the maintenance of the welfare state and not as a deadweight burden ... A modern democratic state requires adequate levels of taxation. The most consistent poll finding we have about tax is that a large majority of people agree with this analysis. ... They believe in the productive enabling state and the means to finance it' (1989, pp.1 and 5).

The tax system is not there only – or indeed, mainly – as a redistributive mechanism. Its role is also to finance the provision of goods and services from which everyone benefits. To understand its function and effects, we have to look at spending at the same time. The overall level of taxation is largely determined by the amount of government spending required, while the effect of government on distribution can only be understood by looking at tax and spending together. Analysing their joint impact is becoming even more important as the Government increasingly uses the tax system – through a widening use of 'tax credits' – instead of what were formerly social security benefits.

This paper sets out the background against which decisions on the tax system are taken, looking at trends in taxation and spending over the last twenty years, at their impact on distribution, and at what we know of public preferences for them. It then considers the impact of recent changes in tax policy since the 1997 change of government.

1. The level of taxation and public spending

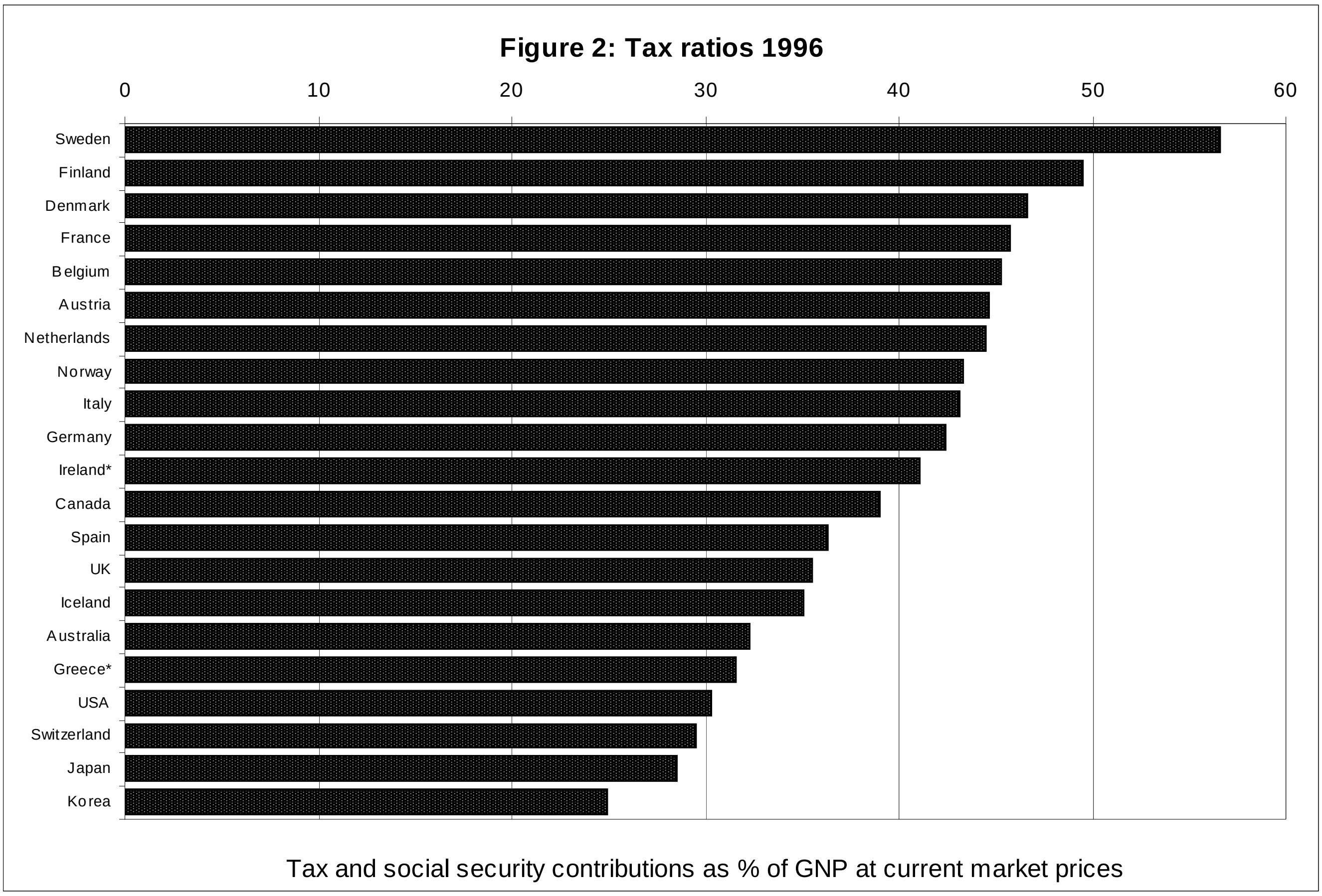
Figure 1 shows how the tax ratio (total tax and National Insurance Contributions as a share of national income) has varied since 1978-79. A first point to note is how narrow in some ways the variation is. From an inherited level of just over 33 per cent, the Thatcher government took tax to 39 per cent of GDP in 1982, near the lowest point of the recession. It then fell back through both the recovery of the late 1980s and the recession of the early 1990s, reaching a low point in 1993-94 back at 33 per cent, before rising again through the recovery of the later 1990s to reach 37 per cent by the end of the decade.



Source: HM Treasury (2000a), Tables C22 and C23.

There is little clear trend over the period (or indeed, looking further back to the start of the 1970s), despite the political sound and fury. Some of the movements relate to the economic cycle, with a tendency for the ratio to fall in economic booms as the denominator, national income, grows rapidly (for instance, 1973, 1979 and the late 1980s) and to rise in recessions (notably the mid-1970s and early 1980s). But politics or the driving force of the public finances can buck such trends, as with the tax-cutting policies set in the run-up to the 1992 election and the subsequent rise to cut back public borrowing afterwards.

One result of this comparative stability over the last quarter century is that the UK has moved from being a country with a fairly typical level of taxation amongst industrialised countries to being firmly in the low tax half of the range. Figure 2 shows that by 1996, Britain's tax ratio (in this case, measured in relation to GNP) put it fourteenth out of the twenty-one countries listed. A similar ranking in 1986 would have put the UK above Spain, Canada and Italy; back in 1975 its ratio was just above the mid-point of the international range.[1]



Source: Fugeman (1999), Table 1.
Note: *1995 figures

The scale of variations between countries is far greater than the range over time in the UK. Four countries including France had tax ratios 10 or more per cent of GNP above that in the UK in 1996, while the lowest, Korea, was ten points below it. Only two other countries, Spain and Iceland, had ratios within the range in which British tax revenues have been confined for the last quarter century. Whatever it is that has constrained this measure of the state in Britain, it is clearly not an iron law of the economics of modern economies. Other

1 Fugeman (1999), Table 1; Hills (1996), Figure 4.3.

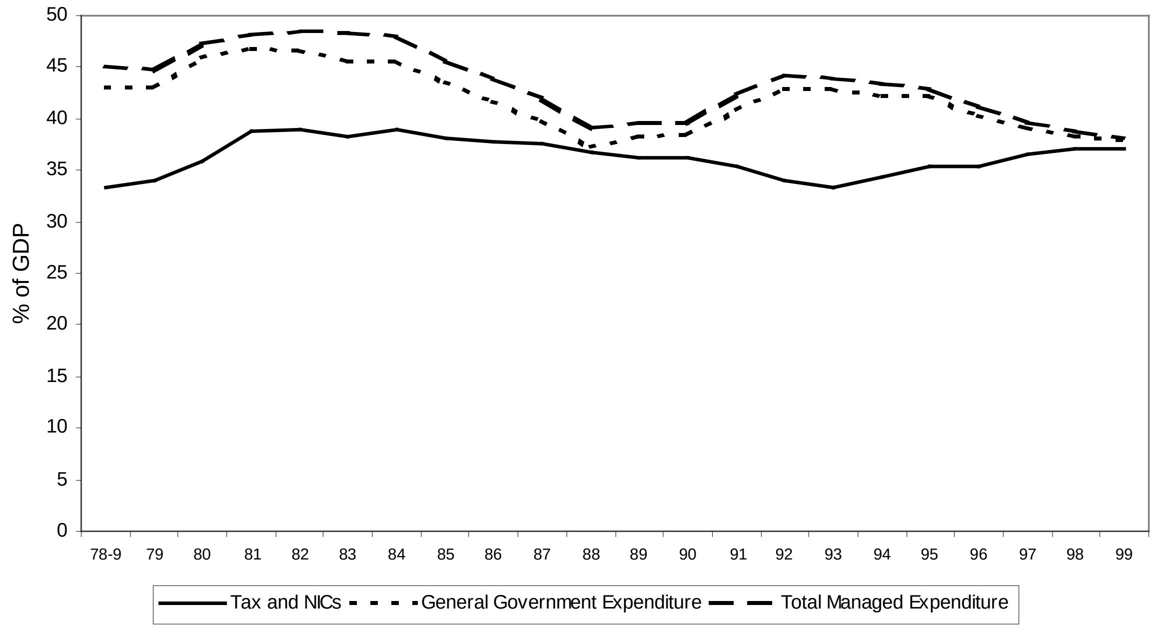
countries – some more successful economically, other less so – have made very different choices.

One of the drivers behind the trends here has of course been the level of public spending. Figure 3 shows the evolution over the same period of two measures of public spending. General Government Expenditure combines central and local government current and capital spending (with proceeds from privatisation counted as a negative item, significantly reducing it in the second half of the 1980s). Total Managed Expenditure – the total on which policy now tends to focus – includes spending by publicly owned corporations beyond their trading revenues as well (a much smaller part of the economy now than in the past). Both measures include depreciation of publicly owned capital as a spending item, amounting to £14 billion in 1999-00 or 1.6 per cent of GDP.[2] In looking at the public accounts it should be remembered that this counts as a revenue item too, deriving from the capital the public sector owns rather than being financed by tax or borrowing. It also has to be deducted when measuring *net* investment – the extent to which the state is adding to its capital stock.

For most of the period, tax revenues have been well below either measure of public spending, with particularly wide gaps at the start of the period shown and in the early 1990s. In contrast to the stability of the tax ratio, there has been a trend towards lower public spending as a share of GDP since 1975-76, when Total Managed Expenditure reached a peak of nearly 50 per cent of GDP. Alongside this, there are clear swings with the economic cycle, with spending on some items like social security rising in recession (and with the denominator, national income, shrinking in the worst recessions).

2 HM Treasury (2000b), Table 1.5.

Figure 3: Tax and public spending 1978-79 to 1999-00



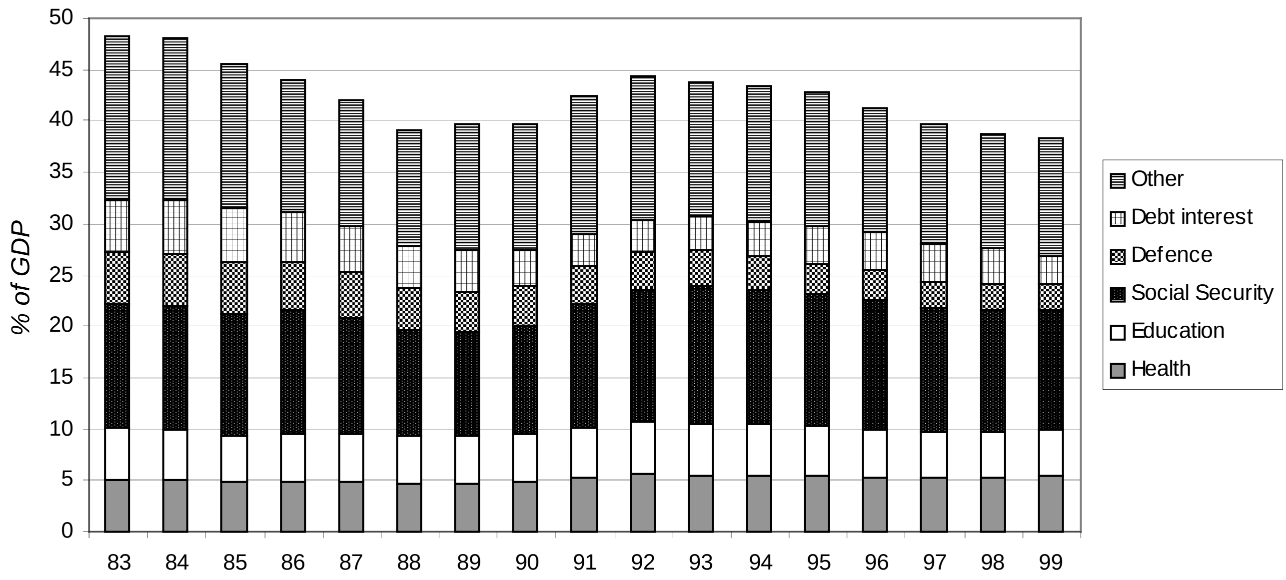
Source: HM Treasury (2000a), Table C22 and C23.

Notably, however, the experience of different items within the public spending total has been very different, as can be seen for recent years in Figure 4. In 1983-84, the three largest elements of the welfare state, health, education and social security totalled about 22 per cent of national income, or 46 per cent of public spending (TME). By 1999-00 they still represented 21.5 per cent of national income, but this was 56 per cent of public spending.[3] This is part of a longer-term pattern of stability – spending on the welfare state as a whole (including housing and personal social services) has fluctuated around a quarter of national income for the whole of the period since 1975.[4] When people talk about the 'inexorable growth of the welfare state', they are talking about a period which ended a generation ago, at the time of the oil crisis and the IMF visit to the UK, predating Mrs Thatcher's election.

3 The plans in the 2000 Spending Review (HM Treasury, 2000c, tables A1 and A2 imply health spending rising by about 0.9 per cent of GDP between 1999-00 and 2003-04, and education spending by 0.8 per cent of GDP, while social security falls by 0.4 per cent of GDP, giving a total of just under 23 per cent.

4 Glennerster and Hills (1998).

Figure 4: Government spending as % GDP
1983-84 to 1998-99



Source: HM Treasury (2000b), Table 4.4, and earlier equivalents.

By contrast, one of the big losers has been defence spending – halved as a share of national income between 1984-85 and 1997-98 – while there were also notable falls in spending on housing, transport, trade and industry, and debt interest. But perhaps the most striking change has been the 'enormous fall in public investment' highlighted by Corry and Neuburger (1997, p.80). The high levels of net public sector borrowing in earlier periods and their more recent falls have to be seen against the background of what was once substantial new public investment. Figure 5 shows the longer term pattern for both public sector net borrowing and net capital expenditure (net of depreciation of existing assets).

What this figure makes plain is the contrast between two periods of high borrowing, the mid-1970s and the mid-1990s. In the earlier period high public borrowing was mainly to finance high public investment. After 1975-76, both fell rapidly, with net borrowing briefly negative in the late 1980s, while net investment fell to near zero – gross investment was barely above depreciation. The huge increase in net borrowing, nearly reaching 8 per cent of GDP in 1992-93 and 1993-94, did not correspond, however, to a surge in investment, but rather to the effects of current spending rising as recession bit, combined with taxes cut ahead of the 1992 election on the strength of what turned out to be wildly optimistic revenue forecasts.[5]

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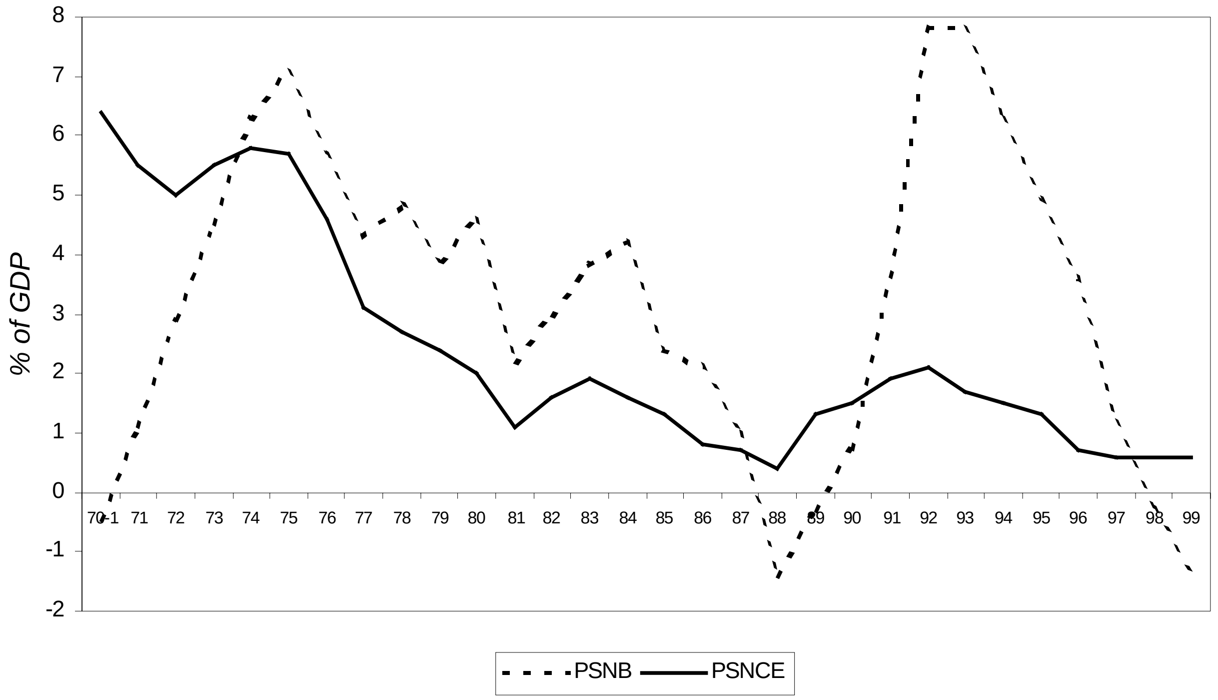
5 Hills (1996), table 4.4.

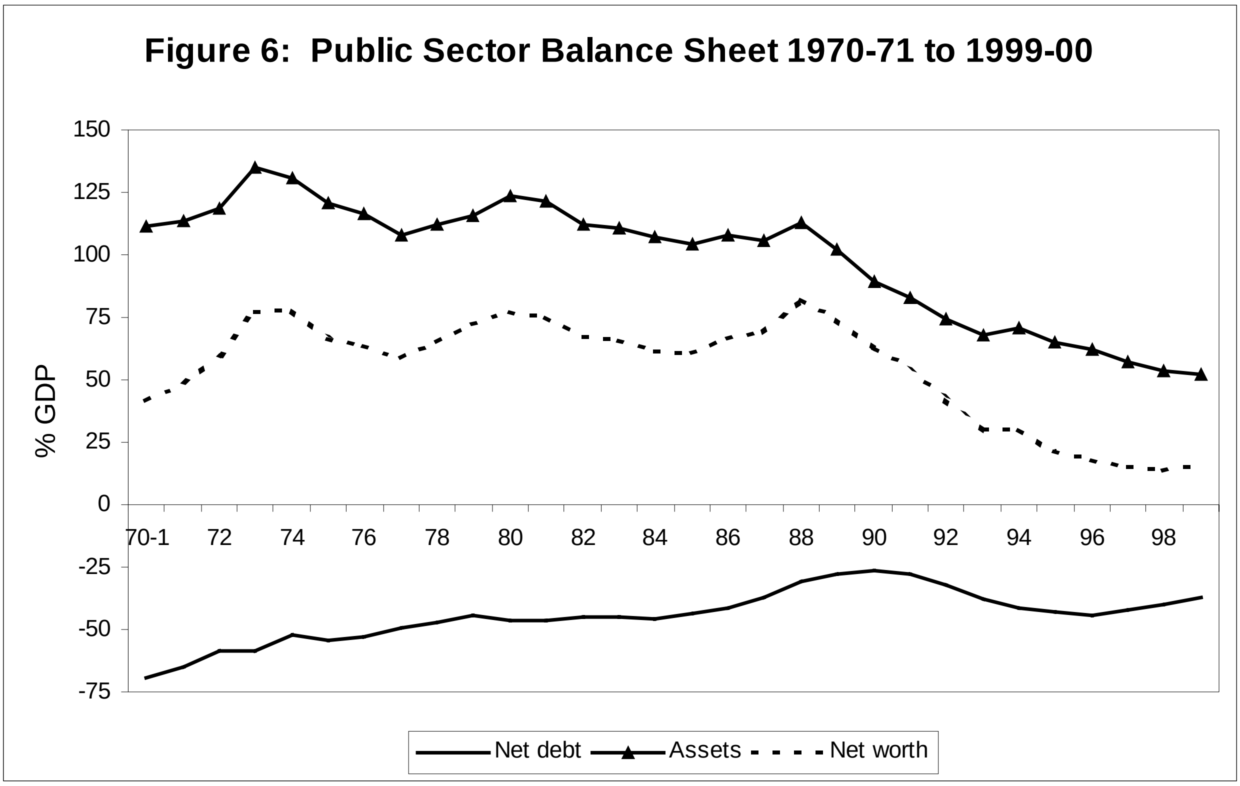
Figure 5: Public sector net borrowing and capital spending 1970-71 to 1999-00



Source: HM Treasury (2000a), Tables C22 and C23.

The relationship between these two totals has been given much greater importance by the current Government through its adoption of the 'Golden Rule' in designing its fiscal policies – that over the economic cycle net borrowing should be no greater than net capital spending, a rule which appeared to be being met in its early years in government for the first time since the early 1970s.

One reason for this rule is the idea of equity between the generations. Another is that of long-term sustainability. Either way, it is argued this generation of policy-makers should not be running the public finances in such a way that later generations will be forced to raise taxes higher than now without any benefit in terms of later public services. Another way of looking at this is through the public sector's balance sheet – the balance between its assets and its liabilities. The most recent official estimates of this are shown in Figure 6 for the same period since 1970-71.



Source: HM Treasury (2000a), Table C23.

Part of what drives this picture is what we have already seen in Figure 5 – the balance between public borrowing and capital spending. But a more detailed look shows that the pattern is more complicated than this. In particular, throughout the 1970s public sector debt was *falling* as a proportion of GDP, despite the high levels of net borrowing. The reason for this was inflation. With public debt denominated in cash, its value fell as prices rose. In 'inflation-adjusted' terms, the public sector was actually not borrowing for much of this period.[6] At the same time, it was investing, so the net worth of the public sector rose from 40 per cent of GDP at the start of the 1970s to reach 78 per cent in 1974. This continued a trend of improvement in this measure since at least the late 1950s.[7] Through the 1980s, the picture is more mixed, with debt falling in relation to national income at the same time as assets (partly as a result of privatisation). In the first half of the1990s, however, net worth falls dramatically – reflecting high borrowing at a time of lower inflation, but low net investment (and continuing privatisation).

In thinking about both generational equity and sustainability, what some of the key fiscal numbers mean is thus very different in what currently appears to be a low inflation world from what they meant in the 1970s and 1980s. This is not

6 Taylor and Threadgold (1979).

7 Hills (1996), table 4.1.

the only reason for caution over the meaning of the balance sheet items shown in Figure 6. The public sector has other assets and liabilities beyond these. The largest of these liabilities is the promises it has made to pay pensions in the future. The capitalised value of people's rights to the basic pension alone exceeds a year's worth of national income, which would turn the net worth of the public sector negative throughout the period shown. Then again, the Thatcher government started the 1980s with the prospect of substantial oil revenues from the North Sea – by the early 1990s revenues equivalent to a windfall asset of more than a third of a year's national income had been used up. Their virtual disappearance puts the comparative stability of public sector net worth in the 1980s in a different light. The loss of most of this revenue also created part of the hole in the public finances which emerged under the Major government.

2. The balance of taxation

When people talk about what is happening to tax, they often focus on income tax, and particularly on the *rates* of income tax – for instance, the 22 per cent 'basic rate' which most people pay on any additional income, or the 40 per cent paid at the margin by people with taxable income (after allowances) of more than £28,400 (2000-01 system). The Thatcher government is thought to have been 'tax cutting' principally because it reduced income tax rates, even though, as Figure 1 showed, the total tax ratio rose thanks to increases in other tax rates such as those of Value Added Tax (VAT) and National Insurance Contributions (NICs). The Blair government's pledge before the 1997 election was, similarly, not to increase income tax *rates* – indeed, the basic rate was cut in April 2000. This did not prevent a rise in the tax ratio in its early years, nor some people paying more income tax, as allowances like mortgage interest relief or the Married Couples' Allowance were abolished.

Yet, as Table 1 shows, income tax is responsible for only 28 per cent of all tax revenues. The rest comes from a variety of somewhat less politically visible sources – notably VAT and NICs (each one sixth of the total) and Corporation Tax (a tenth). Conventionally, the first five items in the table are often described as *direct* taxes – individuals and businesses pay them according to the amounts of income they receive – while taxes like VAT or those on fuel, cars, alcohol and tobacco are described as *indirect* taxes – tax is collected by businesses as they sell goods and services, and the amounts people pay do not depend on their incomes.

Table 1: Taxes and National Insurance Contributions 1999-2000

	£ billion	% total

Income tax (net)	92.3	27.7
NICs	56.4	16.9
Corporation tax (excluding North Sea)	32.9	9.9
North Sea	2.5	0.7
Capital taxes	11.0	3.3
VAT	56.7	17.0
Fuel and VED	27.2	8.2
Alcohol and tobacco	12.0	3.6
Other indirect	6.2	1.9
Council tax and business rates	28.3	8.5
Other	8.0	2.4
Total	**333.6**	**100.0**

Source: HM Treasury (2000a), Table C9.

As a country, Britain makes greater use of indirect taxes than most. OECD figures suggest that only Korea out of fifteen other industrialised countries raises as great a proportion of tax from indirect sources.[8] Most other countries raise much more from social security contributions, the equivalent of our National Insurance Contributions. France, Germany, and the Netherlands raise more than 40 per cent of tax revenue from them, more than twice the proportion here. This reflects the much greater importance (and generosity) of social insurance in those countries as a way of funding items like pensions and hence of contributions.

Over the Conservative years from 1979 to 1997, direct taxes became less and indirect taxes more important. This was mostly, as Table 2 shows, because VAT rose from 9 to 17 per cent of the total, coincidentally mirroring the increase in the main *rate* of VAT from 8 to 17.5 per cent. As Neuburger (1989) discusses, Labour has traditionally been linked to preferring direct taxes and Conservatives to indirect taxes, while the greater visibility of the former has worked to Labour's political disadvantage. As he goes on to argue, these preferences reflect the assumed greater progressivity of direct taxes on the one side, and the idea that indirect taxes interfere less with freedom on the other. He suggests that both ideas are spurious. The second certainly is. Any tax, whatever it is called and however it is collected, puts a 'wedge' between people's income and the (pre-tax) value of the goods and services they purchase. It does not

8 Fugeman (1997), Table 4. This counts the council tax and business rates in the UK as indirect taxes on the grounds that they are effectively levied on consumption, although a case could be made that at least part of the effect of council tax is more like that of other direct taxes.

really matter very much in the end whether someone has an income of £100, pays £20 income tax, and then buys £80-worth of VAT-free goods or alternatively has a tax free income of £100 and buys goods for £100, including £20 of VAT. Both kinds of tax mean that people can consume less from the market than otherwise (in return for the services provided through the state). Both change the pattern of returns to and costs of different kinds of behaviour.

It is also true that indirect taxes are not necessarily regressive (forming a greater share of income of the poor) and direct taxes are not necessarily progressive (forming a greater share of the income of the rich). The Poll Tax was effectively a direct tax, but was highly regressive. Certain kinds of consumption – 'luxuries' – do represent a greater share of income for the rich than the poor. In his analysis of this Henry Neuburger identified items like meals out, car purchase, recreation, holidays and financial services – including saving – which would be more progressive to tax than income.

Table 2: Tax composition 1978-79 and 1999-00

	Share of total tax revenue (%)	
	1978-79	**1999-00**
Income tax[1]	32.9	27.7
National Insurance Contributions[2]	21.1	16.9
Corporation Tax[3]	6.9	9.9
Capital taxes[4]	2.0	3.3
VAT	8.6	17.0
Other indirect	17.6	13.7
Rates/Council tax	10.1	8.5
North Sea	0.9	0.7
Other[5]	-	2.4
All	100	100

Notes:
1. Net of tax credits in 1999-00 (would be 28.3% if measured gross)
2 .Includes NI surcharge in 1978-79
3. Includes Advance Corporation Tax. Excludes North Sea revenues
4. Includes Development Land Tax in 1978-79
5. Includes National Lottery 'good causes'
Source: Kay and King (1980), Table 1; HM Treasury (2000a), Table

However, in practice, indirect taxes clearly are much less progressive than direct taxes. Table 3 shows figures derived from the Office for National Statistics' analysis of the impact of different kinds of taxation by income in 1998-99. Figure 7 summarises the picture. The most striking finding from this is that the British tax system is not, on this analysis, progressive. Overall the taxes allocated by ONS represent 37.1 per cent of household gross income (including income from cash benefits as well as from market sources). But for the richest tenth of households they are below this, and for the poorest tenth they are much higher.[9] In particular, indirect taxes represent 35 per cent of gross income for the poorest, but only 11 per cent for the richest. As is well known, taxes on tobacco are strikingly regressive but taxes on fuel and cars are also regressive.

Table 3: Tax as Share of Gross Income by Income Group 1998-99 (%)

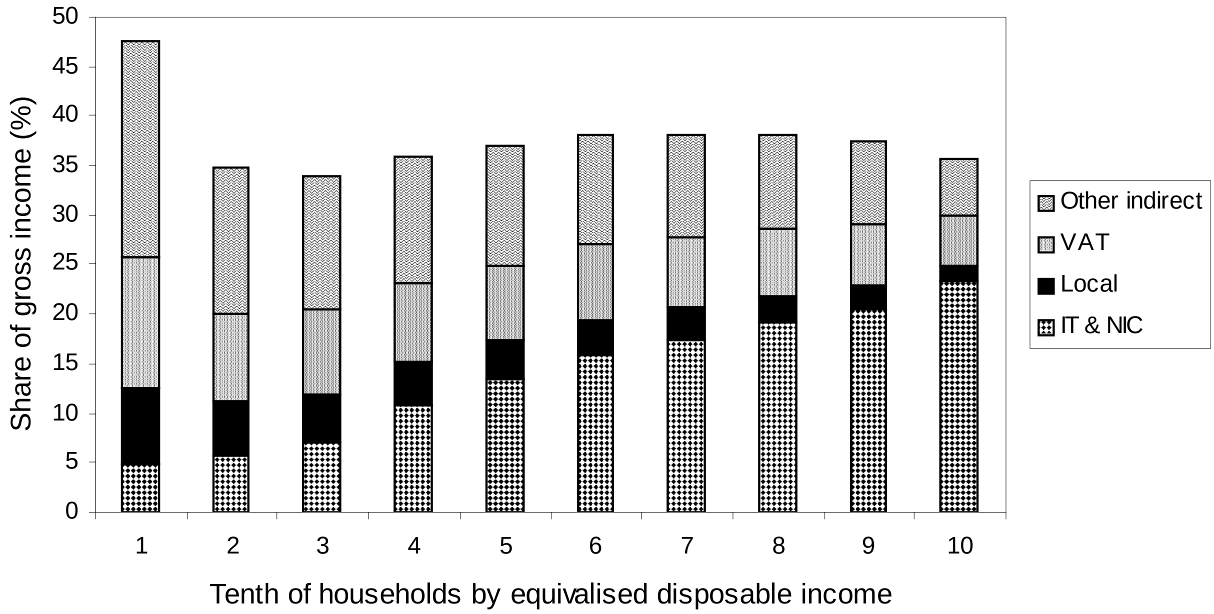
Households by tenth of equivalised disposable income

9 Part of this stems from the high expenditure of households in the poorest tenth in relation to their reported income. To the extent that this reflects misreported or temporary and atypically low income, these figures will overstate the tax burdens at the bottom.

	1	2	3	4	5	6	7	8	9	10	All
Income Tax	3.4	3.9	4.8	7.3	9.4	11.2	12.4	13.8	15.3	19.8	13.5
Employee NICs	1.5	1.8	2.2	3.4	4.1	4.6	5.1	5.4	5.2	5.3	4.2
Local tax (net)	7.7	5.6	4.8	4.5	3.9	3.5	3.1	2.7	2.4	1.6	3.0
All direct	**12.6**	**11.3**	**11.9**	**15.1**	**17.4**	**19.2**	**20.7**	**21.9**	**22.9**	**24.9**	**20.7**
VAT	13.1	8.8	8.6	8.0	7.6	7.8	7.2	6.7	6.2	5.0	6.8
Tobacco	4.0	3.1	2.3	2.3	2.0	1.2	1.3	0.8	0.7	0.2	1.1
Alcohol	1.9	0.9	1.1	1.1	1.0	1.0	1.0	1.0	0.8	0.6	0.9
Fuel and VED	4.3	2.9	2.8	2.8	2.8	2.6	2.5	2.5	2.2	1.3	2.3
Employer NICs	3.0	1.9	1.8	1.7	1.6	1.6	1.4	1.4	1.2	1.0	1.4
Other indirect	8.7	5.9	5.5	4.9	4.6	4.4	4.2	3.9	3.3	2.6	3.9
All indirect	**35.0**	**23.6**	**22.1**	**20.8**	**19.6**	**18.7**	**17.6**	**16.2**	**14.5**	**10.8**	**16.4**
Total	**47.7**	**34.9**	**33.9**	**35.9**	**37.0**	**37.9**	**38.3**	**38.1**	**37.4**	**35.7**	**37.1**

Source: Harris (2000), Table 2A (Appendix 1).

Figure 7: Tax by income group, 1998-99



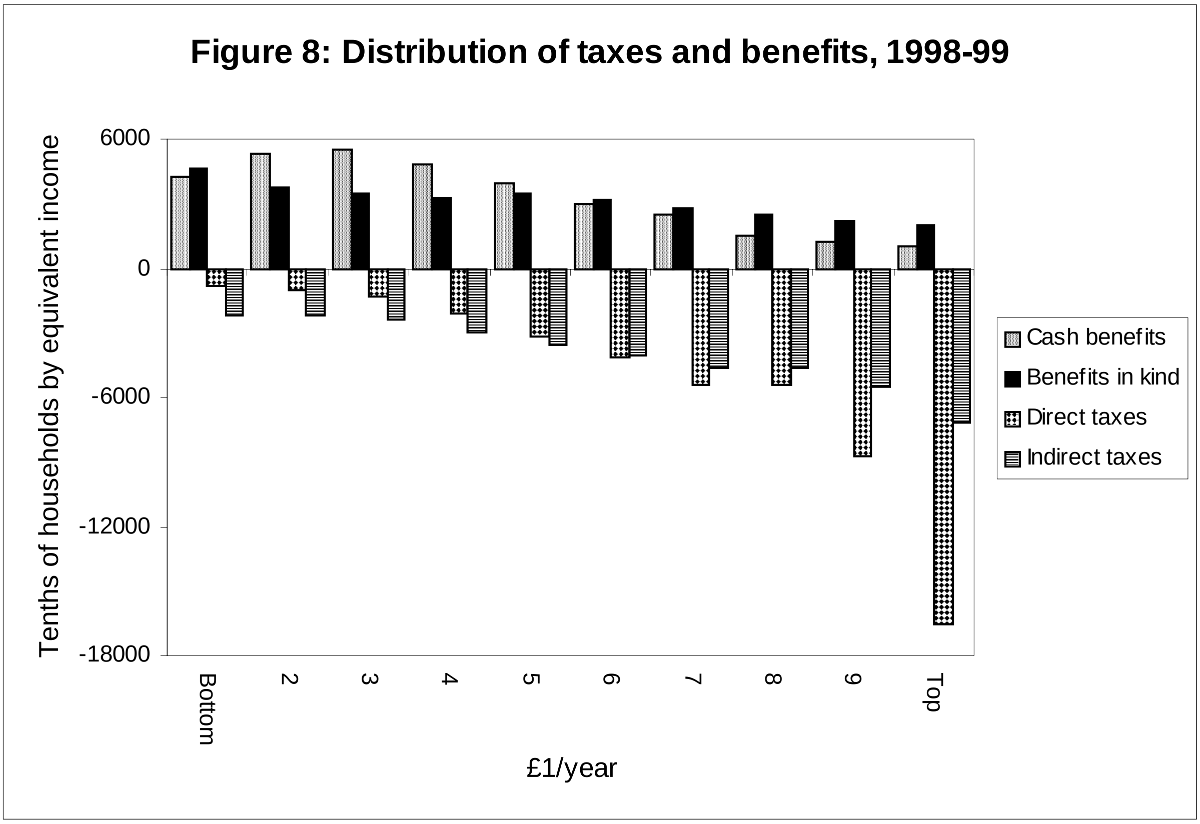
Source: Table 4.

It is hard to make such analyses definitive – to do so, one has to have a clear idea of the *incidence* of a tax – who is really worse off compared with what would have happened without the tax? In this example, the NICs which employers pay as a percentage of the earnings of their employees are classed as an addition to their costs, and are assumed to be borne by consumers, creating their regressive impact. Just as plausibly one could argue that they are as much a wedge between gross labour costs to employers and net pay to employees as income tax and so should be treated the same way. If this was done, they would be shown as more progressive than the employee NICs at the top of the table (because employer contributions are not subject to the earnings limit beyond which employee contributions do not increase – £535 per week in 2000-01). Allowing for such uncertainty, the clearest conclusion is that for most of the income range, the British tax system is roughly *proportional* – one way or another, most income groups pay about the same share of income in tax. But it is only so because of the contribution of direct taxes. Three factors drive the regressivity of indirect taxes:

- People with higher incomes save more (and savings are not subject to indirect taxes – and are not likely to be);
- More of the consumption of those with lower incomes goes on heavily taxed items like tobacco (despite the VAT exemption of necessities like food and lower rates on fuel); and
- Many indirect taxes are set as lump sum amounts (such as vehicle licences or the part of tax on wine which is a fixed amount per bottle whether cheap or expensive).

Again, however, it is important not to look at the impact of taxation in isolation, and assume, for instance, that this means that the state does not have a redistributive effect. The tax system may not be progressive in itself, but what it finances certainly is. Figure 8 shows from the same source the ONS's allocation of both taxes and the benefits of most parts of public spending between income groups. The poorest tenth may pay most tax as a share of its income, but this amount – about £3,000 per household in 1998-99 – is much lower than the amounts allocated to it from social security and from benefits in kind from public services like the NHS and state education, totalling nearly £9,000 per household. The net gain averages nearly £6,000. The same balance holds for the next four tenths of the distribution, although to a declining extent. At the top, tax may be a smaller share of gross income, but the absolute amount – averaging nearly £24,000 – is much greater than the benefits allocated of around £3,000. As with the allocation of the impact of taxation, the precise way the benefits of public spending are allocated here can be questioned, and taking a longer-term lifetime perspective moderates the results,[10] but the overall effect is clear: the *combination* of taxation and the spending it finances is redistributive.

10 See Sefton (1997) and Falkingham and Hills (1995) for detailed discussion of these issues.



Source: Harris (2000).

3. What do people want?

Conventional political wisdom has been that voters want lower taxes and will vote for parties that promise them. In the run-up to the 1997 election, Labour's pledge on income tax rates was backed up with a promise to hold to the Conservatives' very tight spending plans for the following two years. As a result, and helped by a strong economy and falling unemployment, spending (TME) fell from 41.2 per cent of GDP in 1996-97 to 37.7 per cent in 1999-2000.[11]

This belief appears to conflict with what remains one of the consistent findings from the long-running *British Social Attitudes* survey (and from other polls). Since the late 1980s there has been a large majority for *increased* public spending on 'health, education and social benefits', even if this means higher taxes, and only a tiny proportion of the population opts for lower taxes and lower spending on these items. Nearly two-thirds of respondents continued to

11 HM Treasury (2000c), table 49. The plans in the 2000 Spending Review would take TME to 40.5 per cent of GDP in 2003-04.

choose the increased tax and spending option in 1998 during Labour's first two years of spending restraint.[12] Even amongst respondents to the 1998 survey who identified with the Conservative party a narrow majority (51 per cent) preferred increased taxes and spending on these items. 70 per cent or more of Labour and Liberal Democrat identifiers wanted higher spending, and only 25 per cent of either group wanted the current levels. People do indeed seem to support taxation to finance the 'enabling state'.

However, simply wanting *more* tax and spend does not necessarily mean *much* more. Heath and Curtice (1998) show that until 1994 a majority saw Labour as being to their left on the balance between tax and spending: people wanted more spending, but feared Labour would go too far. After then, opinion became much more balanced between those who thought Labour would do too much or too little. Second, different items have higher or lower priority, particularly if the personal consequences of higher taxes are spelt out. Brook, Hall and Preston (1996) show in their analysis of the 1995 BSA survey that majorities remain for higher health and education spending when people are given specific tax consequences for themselves, but not for other items like the police, the environment, and defence. It is little coincidence that health and education have been Labour's spending priorities in office, with Labour now committed to increasing health spending rapidly in the next four years – with plans which would take NHS spending to 6.3 per cent of national income by 2003-04[13] compared to 5.3 per cent in 1996-97 and 5.2 per cent in 1998-99, the second of the two years of fiscal restraint. Nor is it a surprise that Conservative politicians have committed themselves to match these figures.

But what of the more explicitly redistributive part of public spending – the social security budget? First, inequality is unpopular.[14] Four fifths of respondents to the 1998 *British Social Attitudes* survey say that the gap between those with high incomes and those with low incomes in Britain today is too large. Furthermore, three-quarters say it is 'definitely' or 'probably' Government's responsibility to do something about it, against only a sixth who say it is not. When tax is specified as an instrument, more than half say that 'Government should increase taxes on the better-off to spend more on the poor', and only a sixth prefer the statement that 'the better-off pay too much tax already'. However, if the instruments are more closely specified, the scale of agreement reduces. More, but now under half, agree that more should be spent on *welfare benefits* for the *poor*, and a quarter disagree, but only 39 per cent agree that government should *redistribute* income from the better-off to those who are *less well off*, while the proportion disagreeing rises to 31 per cent.

12 Hills and Lelkes (1999).

13 HM Treasury (2000a), tables 5.1 and C3.

14 For further details of these findings see Hills and Lelkes (1999).

Looking at attitudes to the benefit system in more detail reveals a conflict in people's minds. On the one hand, a large majority believes that unemployment benefits are too little to live on (and this reaches 80 per cent when the amounts of benefit are actually specified). On the other, there are increasing concerns about the extent to which benefits for the unemployed cause disincentives and are open to fraud. Until 1996, when asked to choose between the two propositions, that unemployment benefits are too low and cause hardship or are too high and discourage work, the larger group of respondents chose the former.[15] However, the gap had been narrowing and in 1998, the larger group chose the 'too high and discourage work' option.

These competing concerns about inequality, the low level of benefits, disincentives and fraud mean that people react differently to options for different kinds of benefits, as Table 4 shows. In line with the preference for higher spending on 'health, education and social benefits' described above, people generally say they want higher spending on social security benefits. More than two-thirds say they want higher spending on benefits for those who care for those who are sick and disabled, disabled people who cannot work, retired people, and parents who work on very low incomes. Very few call for lower benefits for these groups. When it comes to single parents the largest group opts for the *status quo*, although more still opt for extra spending than lower on benefits for this group. By contrast, while the largest group again go for the *status quo* for benefits for unemployed people, in this case more say they would like to see lower than higher spending on them.

Table 4: Would you like to see more or less government spending on benefits for…

	Spend more	**Spend the same as now**	**Spend less**
People who care for sick or disabled	82	15	1
Disabled people who cannot work	72	23	2
Retired people	71	25	2
Parents who work on very low incomes	68	26	3
Single parents	34	41	21
Unemployed people	22	40	35
Base: 3146			

Source: Hills and Lelkes (1999) based on British Social Attitudes survey.

15 Unpublished information kindly supplied by the National Centre for Social Research from the partial survey in 1997 shows this was still true then.

These responses have two important implications. First, as with health and education spending, public preferences are clearly for increases in spending on the bulk of the items making up social security, even if this means higher taxes, rather than the reverse. What is often not realised is that social security spending is overwhelmingly on the groups which are favoured in the table. Only 21 per cent of the 1998-99 social security budget went on the non-disabled population of working age; only 6 per cent directly on the unemployed.[16]

But second, policies based on across-the-board benefit increases would not necessarily be popular if benefits aimed at the unemployed were included. This does not necessarily reflect lack of concern about unemployment, poverty or inequality. It may be as much a judgement about appropriate instruments. Two-thirds of the 1998 *BSA* survey respondents agreed that, 'it should be the government's responsibility to provide a job for everyone who wants one' – a policy going well beyond the measures included in the 'New Deal' (against a quarter who said it should not be). 'Jobs not higher benefits' would best summarise public attitudes to the unemployed in general. Again, it is perhaps unsurprising that the Government's welfare reform slogan has been 'work for those who can, security for those who cannot'.

4. Recent developments in taxation

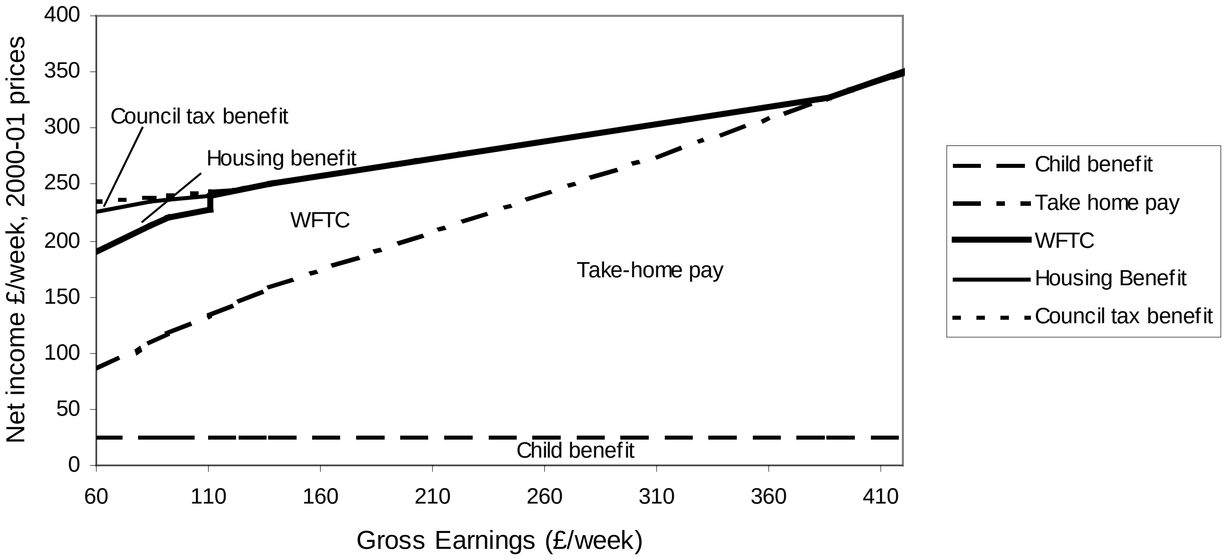
Some of the key developments in policy under the Labour government since 1997 have been described above, notably the adoption of the 'Golden Rule' for the public finances, the election pledge not to raise income tax rates, the tight constraints on public spending in 1997-98 and 1998-99, and the rapid increases in health and education spending planned from 2000-01. But another central part of policy has been in its agenda on work and poverty. First, the centre piece of its initial policies was the 'New Deal' for the unemployed, with a series of measures designed to support people – focussing initially on the young unemployed but extended to other groups without work – into jobs. This was financed by a one-off £5.2 billion 'windfall tax' on some of the utilities privatised by the Conservatives. Second, early in 1999, Tony Blair promised to 'end child poverty' within 20 years, and a series of measures in the Budgets between 1998 and 2000 channelled extra resources to families with children in particular, but also to others with low incomes.

A key innovation to serve both the aim of promoting work (by ensuring that 'work pays') and of attacking child poverty has been the replacement since October 1999 of what was a social security benefit for low paid families with

16 DSS (2000a), chart 1.1.

children, Family Credit, with a new Working Families Tax Credit (WFTC). This is more generous than its predecessor, is withdrawn more slowly as earnings rise, and is intended to be administered differently – through the tax system and the pay packet, rather than paid out as a benefit. It remains to be seen whether the change in payment system has the psychological effects which are hoped for it – reducing stigma and linking the payment to work rather than being seen as a hand-out – and whether the administrative systems cope as people move between jobs and in and out of work. Initial analysis suggests that the impact of increased incentives to work on employment will be positive, but

Figure 9: Gross and net income, under Budget 2000 system



relatively modest.[17] However, the distributional effects are clear and substantial.

Note: Includes Child Tax Credit, full reform of NICs and June/Oct 2000 increases in child elements of WFTC and HB/CTB. Rent assumed to be £50 per week, and Council Tax £14 per week.

Figure 9 illustrates how the credit works, showing the relationship between gross and net income resulting from the interaction between direct taxes, benefits, and the WFTC for a one earner couple with two children. The figures are shown in 2000-01 prices, but incorporate the effect on income tax (and hence take-home pay) of the Child Tax Credit which was announced in the 1999 and 2000 Budgets, but will only start in April 2001. Several effects of the WFTC are apparent:

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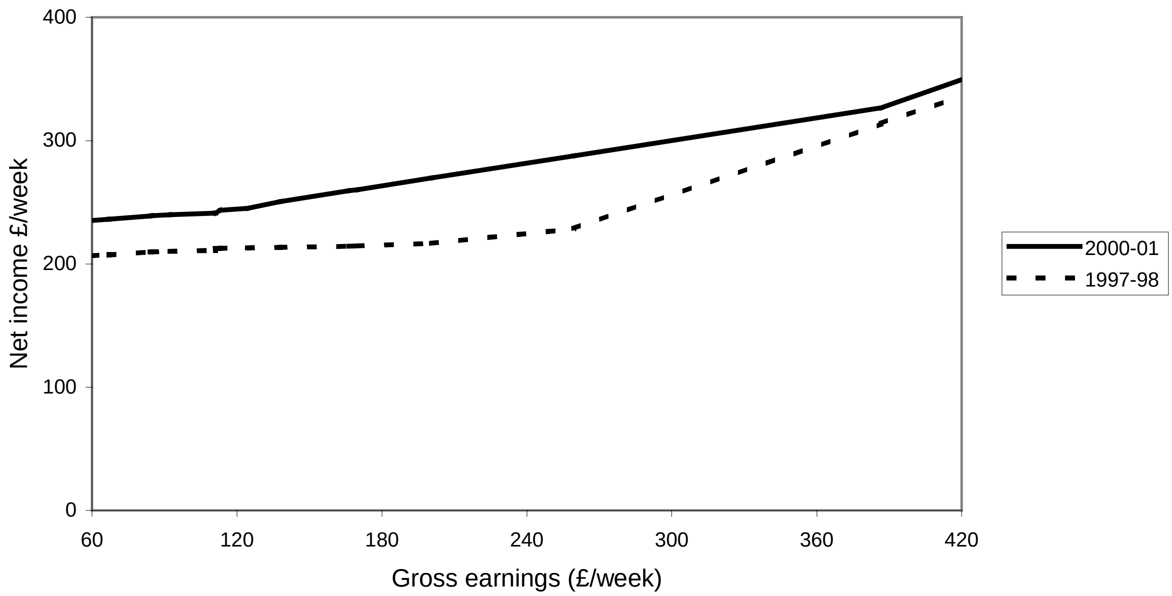
17 Blundell *et al.* (2000) suggest an increase in participation of around 30,000 people, with a benefit to the public finances which reduces the net cost of the increased generosity of WFTC by about a seventh.

- It makes a sizeable contribution to those with low earnings – up to £104 per week for those with the lowest earnings, and more for those working over 30 hours per week.[18] As the Government is keen to stress, someone working full-time at only the minimum wage would have take home pay and WFTC of at least £208 per week, compared to benefit income out of work for this family of £158 per week (although allowing for housing and council tax benefits the gap is smaller).
- Its effect is to carry most working families, except those with very low pay, off Housing Benefit and Council Tax Benefit (unless rent is much higher than the typical council rent used here).
- This, in combination with the lower, 55 per cent, WFTC withdrawal rate as income rises means that the most severe aspects of the 'poverty trap' – where higher gross earnings have little effect on net incomes – have been reduced.
- Entitlement to the credit extends well up the earnings scale, nearly to average earnings in this case. As a corollary of the reduced *depth* of the poverty trap, a milder version of it affects more people.

Figure 10: Net incomes 1997-98 and Budget 2000 systems



Note: 2000-01 system includes Child Tax Credit, full reform of NICs, and June/Oct 2000 increases in child elements of WFTC/HB. 1997-98 system uprated by statutory indexation to April 2000.

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18 In the figure it is assumed that earnings of £111 or more represent at least 30 hours work. In practice, the jump in the WFTC schedule could come at higher earnings levels for those earning more than the minimum wage.

Figure 10 compares the relationship between gross earnings and net income under the system created by the 1997 to 2000 Budgets with what the situation would have looked like if the tax structure and benefit rates of April 1997 had simply been adjusted by the rules for 'statutory indexation' for inflation up to April 2000. The difference between the two reflects not only the introduction of the WFTC, but also a number of other important changes, including:

- Reduction in National Insurance Contributions for the low paid (taking account of the reforms to be finalised in April 2001).
- Abolition of the Married Couples Allowance in income tax and its replacement by higher rates of universal Child Benefit and the Child Tax Credit (the latter actually in effect in April 2001).
- Higher elements for children in means-tested benefit rates.
- Replacement of the old initial 20 per cent rate of income tax with a 10 per cent band.

Taken together the Budget measures mean significantly higher net incomes for this kind of family over a wide range of below-average earnings – more than £25 per week at the lowest levels, rising to a maximum of nearly £60 at the point where Family Credit would previously have run out.

This kind of example suggests that the reforms to the tax and benefit system since May 1997 have significantly helped low paid families with children. However, what is in effect a single family type (a one earner couple with two children aged under 11) represents a small minority of the population as a whole,[19] and it is this group which has been most favoured by the reforms. The impact of the reforms on the population as a whole might look very different. To establish this one needs to look at their effects on a representative sample, and to compare the net incomes generated by the tax and benefit system resulting from the reforms with calculations of what they would have been in the absence of reform. The results of such an exercise, carried out on the Cambridge University Microsimulation Unit model, POLIMOD, are shown in Figure 11. This compares the results for the whole population of the system created by the Budgets between 1997 and 2000 with an 'unchanged' system, as it was in April 1997 (but with benefit rates and tax thresholds adjusted for inflation according to the rules for 'statutory indexation'). They update estimates of the impact of the Budgets up to 1999 given in Piachaud and Sutherland (2000). The columns show the difference in net incomes (adjusted for family size, or 'equivalised') for each successive tenth of the income distribution, with the poorest tenth on the left. Results are shown for all households and for just those with children in each tenth.

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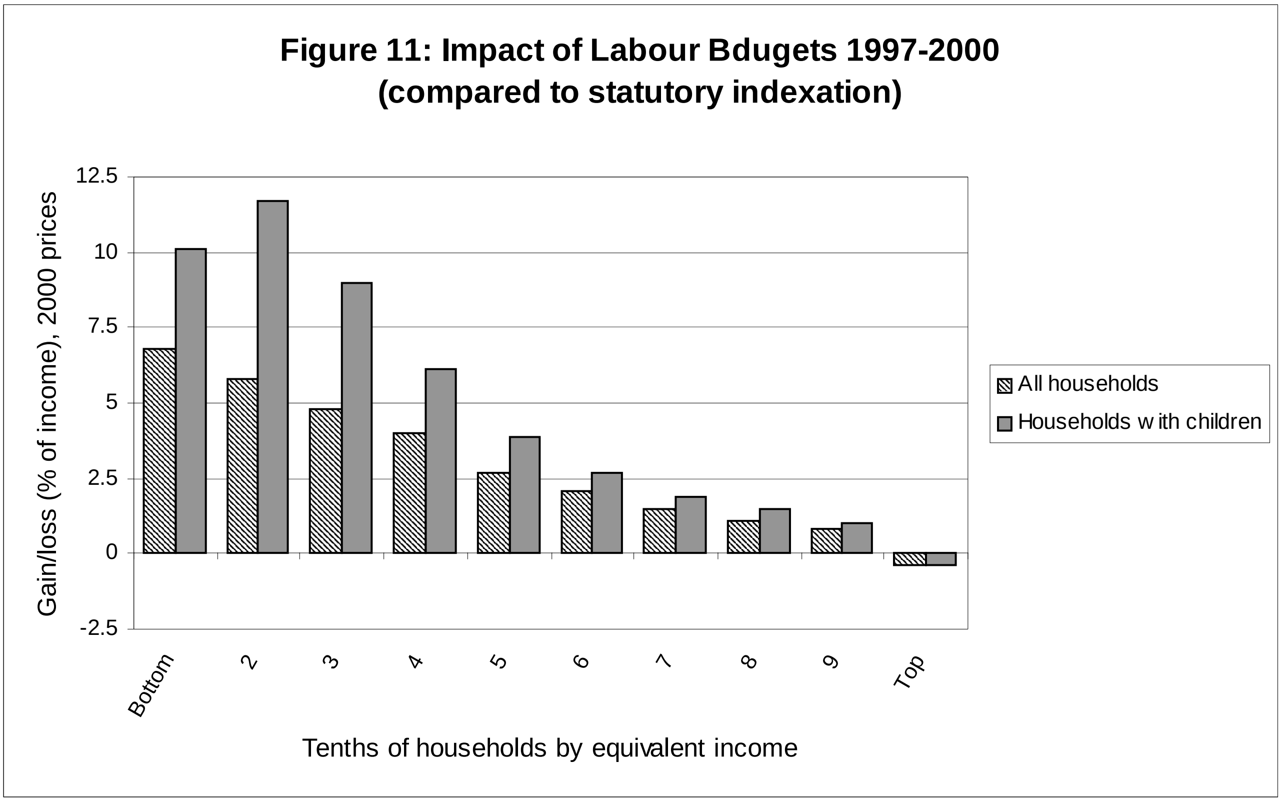
19 Families consisting of two adults with two children, regardless of earnings status, made up just over 9 per cent of all households in 1998-99 (Harris, 2000, table 7, appendix 1).



Source: POLIMOD.

The reforms analysed include those described above to National Insurance Contributions, benefits for children, the WFTC, abolition of the Married Couples Allowance and introduction of the Child Tax Credit, the basic rate cut to 22 per cent and replacement of the 20 per cent income tax band with the 10 per cent band. They also include: introduction of the minimum wage; the winter fuel allowance for pensioners (at £150 per year); the more generous rates of Income Support for pensioners (the 'minimum income guarantee'); the real increase in the upper limit for NICs; abolition of mortgage interest relief; abolition of special benefits for lone parents; and reduction in Incapacity Benefit for those with pension incomes. They do not take account of indirect tax changes (which include higher taxes on tobacco and petrol but lower VAT on domestic fuel), or of the change to the taxation of pension fund income announced in July 1997.[20] Nor do they allow for any benefits from lower

20 It is hard to establish what the distributional impact of this measure was given that its effect could be higher employee contributions than otherwise to occupational pension schemes, lower pensions to be paid out by them in future than otherwise, or lower contributions by firms to their schemes (or fewer 'contribution holidays' for them). The impact – on current contributors to schemes, on future occupational pensioners, or on shareholders – is likely to have been progressive, so that if one could adjust for

unemployment as a result of macroeconomic management or the New Deal programmes or for any changes in behaviour (such as increased labour force participation) resulting from the reforms. They do, however, give a clear indication of the impact of many of the most important measures.

Overall, the reforms have a net cost to the Exchequer of around £6.7 billion.[21] This includes £1.2 billion from the WFTC compared with Family Credit, £1.1 billion on the pensioners fuel allowance, £1.4 billion on higher Child Benefit, £2.2 billion on higher Income Support and non-means-tested Job-Seekers Allowance (from higher child allowances and higher rates for pensioners), and £1.9 billion from reduced NICs. The income tax changes (excluding the WFTC) largely cancel one another out, and other measures raise a little over £1 billion net.

Allowing for a £1.3 billion increase in gross earnings from the minimum wage, households gain £8.1 billion overall – an increase in average household income (adjusted for household size) of 1.7 per cent. As Figure 11 shows, however, gains are much larger than this for lower income groups on average, particularly those with children. The poorest tenth gain nearly 7 per cent (10 per cent for those with children), and the next tenth nearly 6 per cent (12 per cent for those with children). In percentage terms these gains fall as one goes up the distribution, while the richest tenth is 0.4 per cent worse off than it would have been in the 'indexed' 1997-98 system. On this comparison, the four Budgets since 1997 have clearly had a progressive effect, with significant gains at the bottom and small losses at the top.[22] Allowing for indirect tax changes the gains at the bottom would be somewhat smaller,[23] and if one could take account of pension fund taxation the losses at the top would be larger, giving a more clearly redistributive picture. It should also be noted that the changes have varying effects *within* income groups, so that even for families with children in the poorest tenth, 25 per cent are 'losers' under the changes (for instance, some lone parents with older children), while 75 per cent are 'gainers'.

One of the main controversies around New Labour's policies has been what one can call its 'selective universalism' – increasing some social security benefits, but not others, and spending on some services like health and education but not others. Critics on the left have called for increases in *all* social

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this the figures shown in Figure 11 would become less favourable to those at the top of the distribution.

21 Not allowing for the cost of raising public sector wages to comply with the minimum wage.

22 For more detailed analysis of the effects of the first three Budgets, see Piachaud and Sutherland (2000).

23 A similar exercise carried out by the Institute for Fiscal Studies after the 2000 Budget suggests gains of 9 per cent to the poorest tenth from the 1997-2000 Budgets and a loss of about 0.5 per cent for the richest tenth (*Guardian*, 23 March 2000, p.28).

security benefits beyond the rate of inflation – for instance for the basic state pension to be increased with earnings rather than just with prices. Without this, the *relative* living standards of those dependent on benefits will fall.

It should also be noted that 'statutory indexation' of the benefit and tax systems actually delivers a gain, other things being equal, to the public finances. First, if benefits are only price-linked, and incomes are growing in real terms, the cost of social security falls in relation to national income and to taxes taking a constant share of it. Second, if features of the direct tax system like the personal allowance or threshold for higher rate tax are *only* uprated for price inflation, rising real incomes pull taxpayers higher up the schedule. This 'fiscal drag' means that tax rises as a share of income. Chancellors can 'index the system' but still benefit from a rising direct tax ratio.

For both these reasons, it is interesting to compare the results of New Labour's fiscal policies with an alternative 'neutral' policy. What would have happened if all benefit rates and all the features of the direct tax system which are set in cash terms had been increased not just in line with price indexation,[24] but in line with income growth? After all, other things (such as changes in unemployment or demography) being equal, this kind of uprating would be consistent with a constant tax ratio and constant social security spending as a share of GDP (and thus with continued fiscal stability if this had been achieved to start with). It can be argued that this is a more appropriate 'steady state' benchmark than price indexation.

The Treasury forecasts that between 1997-98 and 2000-01 money GDP will have grown by 16 per cent.[25] Figure 12 shows the distributional effects, again by comparison with statutory indexation, if all benefit rates and direct tax thresholds had been uprated by this amount. First, instead of the net cost to the public finances of £6.7 billion compared to indexation from actual policies, this alternative would have had a net cost of £9.2 billion. Uprating with incomes would have meant £6.4 billion in higher benefits, compared to the £4.8 billion under actual policies (including the WFTC as a benefit for these purposes). The Government has indeed spent less than it would have done under an 'Old Labour' policy of uprating all benefits with incomes. At the same time, uprating with incomes would have meant £2.7 billion *lower* direct taxes (mainly income tax) than under statutory indexation. This gives the measure of the fiscal drag from which the Chancellor has benefited – more than the £1.9 billion he has 'given away' in his reforms to NICs, which explains one of the ways in which the tax ratio has risen despite the tax cuts.

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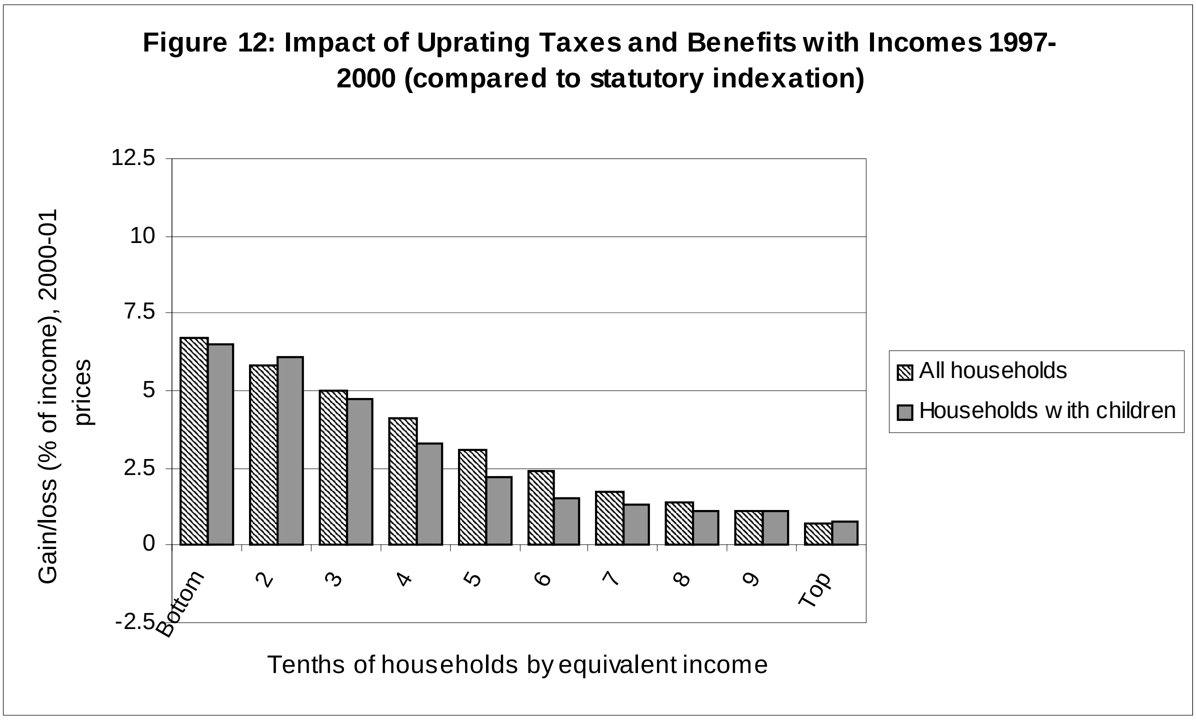
24 Some features of the tax and benefit system are not even adjusted for inflation under statutory indexation as they are not covered by it – for instance, earnings disregards or the capital limits for means-tested benefits.

25 HM Treasury (2000a), table C3.



Source: POLIMOD.

Overall, household incomes would be 2.1 per cent higher under this 'neutral' policy than under statutory indexation. As benefits are the most important part of this, the largest 'gains' are at the bottom – nearly 7 per cent for the poorest tenth, and 6 per cent for the second group. Effectively, this is the increase in real benefit rates needed to keep up with rising overall living standards. The top tenth would have gained 0.7 per cent (mainly through the elimination of fiscal drag). The comparison with Figure 11 is instructive. Overall, the bottom four tenths do almost exactly as well under New Labour's policies as they would have done if all benefits had been linked to incomes without any change in structure. This is despite the £2.5 billion lower net cost to the public finances of actual policies. About half of this lower cost reflects the gains coming from outside government through the minimum wage. The other half is because the higher income groups do slightly worse under actual policies, and the top tenth is one per cent worse off under them. Within the lower income groups families with children do better than under straight income indexation, so other groups do worse.[26]

One assessment of the Government's record would thus be that it has simultaneously delivered as much to low income groups as more expensive

26 For instance, while households with pensioners in the bottom tenth of the overall distribution gain as much – 8 per cent – under both policies, those in the second tenth gain 4.3 per cent under actual policies, but would have gained 6.4 per cent under income indexation.

‘Old Labour’ policies would have done, while generally going with the grain of the progressive parts of public opinion described in section 3, reforming the structure of the system to improve work incentives overall,[27] and delivering the improvement in the public finances charted in section 1. In these terms, it is a very impressive achievement.

Alternatively, one could say that the tax and benefit reforms have only barely delivered enough to the lowest income groups as a whole to prevent inequality rising: any actual catching up of relative living standards at the bottom will have to come from the improved labour market and rising numbers in work and off benefits. By themselves the measures may stem the tide of rising inequality, but not reverse it. And even to continue standing still in these terms will require a flow of new measures benefiting the poor. This may be hard if the case for financing them has not been made through positive promotion of what is needed as well as what has been achieved.

Official calculations suggest that the measures taken so far ‘will lift 1.2 million children out of poverty’,[28] using a poverty line of half average income. Independent analysis confirms this order of magnitude for the reduction in the numbers *compared to those if no changes had been made*.[29] However, it is still too early to tell whether child poverty will actually fall by this amount, and indeed whether inequality and poverty as a whole will fall. This is for three reasons. First, tax and benefit changes are only part of the picture. What happens to unemployment and the distribution of market income also matters. Second, inequality and relative poverty measures like half average income set Government a moving target: real income increases at the bottom are needed just to keep up with rising living standards. Without them, inequality and relative poverty will rise. We will not know how all these factors play out until we see analysis of the actual income distribution, rather than just the simulations of the kind shown in Figure 11.

But there is a third problem, highlighted by the latest official income distribution figures published in April 2000 shown in Figure 13. This shows the Gini coefficient measure of household income inequality over the period from 1977 to 1998-99, Labour’s second year in office. It shows inequality of four measures of income, reflecting the impact of the tax and benefit system as described in section 2: market income; gross income (which includes cash benefits); disposable income (which deducts direct taxes from this); and post-tax income (which deducts the ONS’s estimates of indirect taxes as well). The picture in earlier periods shown will be familiar to those who have followed the story: market income inequality grew almost continuously from 1978 to the

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27 Although not for all groups, as Piachaud and Sutherland (2000) explain.

28 HM Treasury (2000a), p.8.

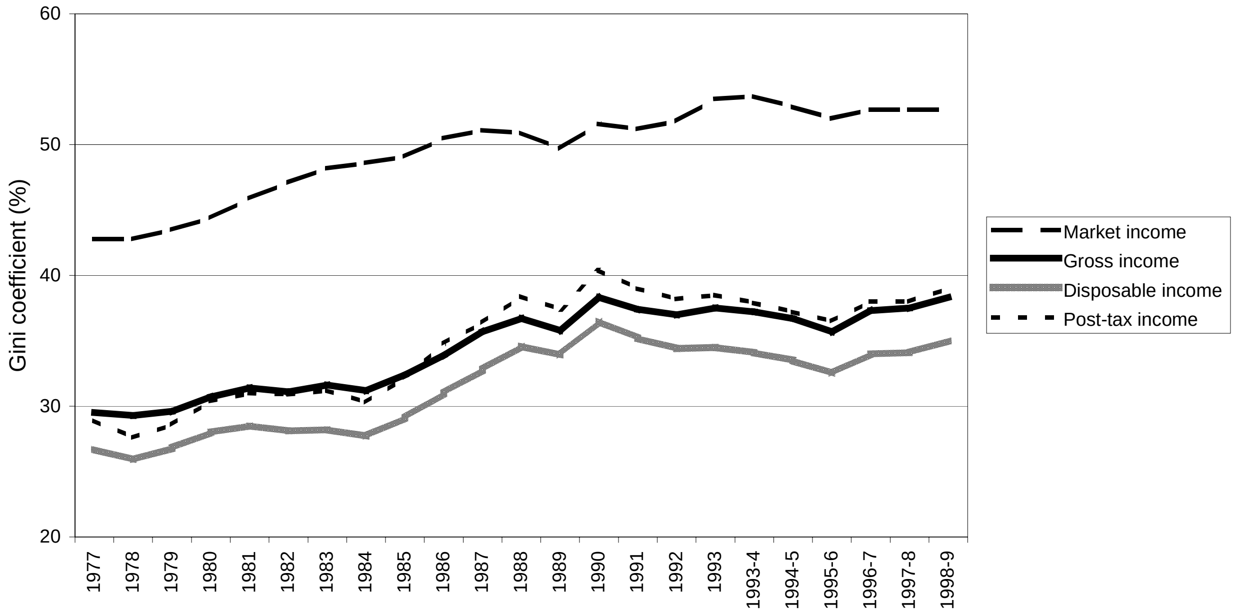
29 Piachaud and Sutherland (2000).

early 1990s; the other measures grew less in the early 1980s, but very rapidly in the second half of the decade; under the Major government there was first a fall and then a rise in inequality.

What is new in these figures is the picture it gives of changes between 1996-97, the Conservative's last year in office, and 1998-99, Labour's second year. While market income inequality did not change, the other measures each *rose* by one percentage point. As most of this occurred between 1997-98 and 1998-99, inequality clearly rose at the start of Labour's time in office. What was happening was that gross incomes at the bottom – largely driven by benefits, which remained price-linked – were falling behind rising real incomes higher up the distribution. As a result the total numbers with incomes below half the average – the nearest measurement we have to a poverty line – rose between 1996-97 and 1998-99.[30]

30 By between 0.5 million measured before housing costs or 0.2 million after housing costs (DSS, 2000b), table H1.

Figure 13: Effects of Taxes and Benefits on Inequality 1977 to 1997-98



Source: Harris (2000). Figures are for inequality of household incomes.

Table 4: Tax and Benefit Reform Implementation Lags

Measure	Announcement	Start	Full effect	Visible in distribution statistics
New Deal	July 97	Jan 98	1998-99	2000
Minimum Wage	Manifesto	Apr 99	1999-00	2001
NIC reform (1)	March 98	Apr 99	1999-00	2001
WFTC	March 98	Oct 99	2000-01	2002
Child Benefit, children's benefit rates	March 98	Apr 99	2000-01	2002
NIC reform (2)	March 99	Apr 01	2001-02	2003
Child Tax Credit	March 99	Apr 01	2001-02	2003
Integrated Child Credit	March 00	2003?	2003-04	2005

How can this be reconciled with the picture given in Figure 11? The answer is the time-lag effect, summarised in Table 5. Few of the reforms discussed above were announced until March 1998 or later, while one of the features of tax policy under New Labour has been the gap between announcement of policies and their implementation. By 1998-99, *none* of the reforms benefiting the bottom of the distribution analysed in Figure 11 was in place; the WFTC will only have its full effect in 2000-01; some measures will not have their full effect until 2001-02. While in some cases this kind of delay is inevitable given the administrative reforms required, it does mean that it is too early to judge whether New Labour's strategy for tackling poverty and inequality is a success. Indeed, for those not directly affected by the measures themselves it will be some time before we can gauge their impact from official analysis of the income distribution. This takes time. For instance, on previous patterns, it will be 2002 before we see either the ONS analysis of the household income distribution for 2000-01 or the key DSS figures for *Households Below Average Income*, which will give us a clear picture of the impact of the WFTC, a reform announced in March 1998.

Conclusion

Writing in 2000, an analysis of the kind presented in this paper shows a better balance in the public finances than would have been the picture at almost any point in the last quarter century. This is not just a matter of steady economic growth, fiscal stability, and the 'Golden Rule'. It is also that the balance of tax and spending changes announced since 1998 has real prospects of helping growth in living standards for the poor, while carrying the weight of public opinion behind the measures used to do this and to improve public services. At the same time, if progress is going to be made towards the abolition of child poverty in twenty years promised by the Prime Minister, the measures described above will have to be added to every year. Otherwise, incomes at the bottom will slip behind again, as they did up to 1998-99. This will not be possible if taxation is thought of by politicians and the public as simply a 'burden', and if the positive, enabling results of what it finances are left unconnected to it.

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