



SMF REPORT: ABOLITION OF THE 10P TAX BAND

SUMMARY

- The abolition of the 10p tax band created 5.3 million losers as well as nearly twice as many winners.
- The Chancellor indicated in a letter to the Treasury Committee that he intended to compensate some of the key losers from the changes that came into force at the start of this month.
- However, the Treasury's options are limited because of the difficulty of specifically targeting the losers with any of the existing mechanisms in the tax and benefit system. A further restriction is that the government has very little money, less than £1bn, to play with.
- According to our calculations this is likely to mean that the compensation package is will help less than ¼ of the losers, and will involve using mechanisms like the minimum wage and the pensioners' winter fuel payments for things they were not really designed to do.

BACKGROUND

In his last Budget in charge of the Treasury, Gordon Brown produced a comprehensive set of ambitious tax reforms aimed at simplifying the tax system and lifting children out of poverty. Key among those changes were moves to:

- align the National Insurance Contributions Upper Earnings Limit with the higher rate tax band
- cut the basic tax rate to 20%
- remove the 10p tax rate he introduced in 1999
- substantially increase the level of income up to which families can receive tax credits
- greatly increase the level of Child Tax Credit to tackle child poverty

GROUPS AFFECTED¹

The IFS has estimated that for people of working age 40% are winners from these changes, 40% see no change and a further 20%, around 5.3 million people, lose financially. These losers can be broadly broken down into five key groups:

¹ Calculations base on IFS evidence to Treasury committee and author's calculations

1. Young childless workers aged 16 to 24 (~1 ½ m losers)
2. Single childless people aged 25 to 60 (~1 ½ m losers)
3. Two earner couples with children (~0.7m losers)
4. Working couples aged 25 to 60, without children (~1m losers)
5. Pensioners aged 60 to 64 (~300,000 losers)

Of these groups, the government is less concerned with the two-earner couples with children and the childless couples, since their losses are typically very small and their incomes are all above the £19,000 mark.

The three remaining groups lose for the following reasons:

- those childless people under 25 who, in earning less than £18,000 per year, lose more through the 10p rate abolition than they gain through the accompanying 2p rate cut in the basic rate. These younger workers can lose up to £200 per year. Due to their age they receive no protection from tax credits.
- single childless people 25-and-over who earn between £13,000 and £18,000 are consequently not entitled to any Working Tax Credit to compensate them for the tax losses they face. On average these people lose about £125 per year. For those earning below £13,000 tax credit increases more than offset the net tax rise.
- Women pensioners aged 60 to 64 don't see the benefit of increased pensioner tax allowances that are extended to their older compatriots.

The overall Budget package was a progressive set of direct tax reforms. It gave people in the bottom fifth of the income distribution more than it did any other section of the population and low-earning families with children gained substantially. This all means that from a lifecycle point of view, the 2007 Budget represents a substantial improvement in the tax benefit system for the less well-off, even many of those who lost out on the first day of the tax year.

- While **low-income, single, childless people** (those over 24) may lose up to £130 per year, should anything about their circumstances changes – they find a partner, have a child or get a modest pay-rise – in their new state they will almost certainly be better-off under this year's tax system than under last year's.
- Somewhere around 1½ million **young pensioners** who lose marginally between the ages of 60 and 64 will benefit by over £300 each year from age 65 onwards.

Since the benefits of the 10p tax band were poorly targeted on low-income workers, its introduction in 1999 was pitched as an effort to tackle low-income poverty before the much more targeted tax credit system was fully developed. Abolishing the 10p rate was always on the cards once the new system had bedded-down. But those who have lost out from the abolition of the 10p rate have still gained since Mr Brown moved into No. 11. This is principally down to reforms to national insurance contributions and the reduction in the basic tax rate. Furthermore, childless individuals on the very lowest incomes, have gained substantially.

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THE CHANCELLOR'S OPTIONS

Yesterday the Chancellor wrote to the Treasury Committee outlining his intention to help single childless people and pensioners. The letter was short on detail however, and the PM has indicated that the money available for such a compensation package is a lot less than £1bn. The Treasury has said it will develop the compensation package in time for the Autumn Pre-budget report. Here's how the Chancellor might put flesh on the bones of the things he outlined yesterday. The table below gives more detail.

- **Younger workers.** The Chancellor has not promised to help this group explicitly through the tax-benefit system.

His options are:

- **Extend the working tax credit to childless people in this group.** This would be expensive and complicated, taking some time to introduce, but would tackle the losses for this group.
- **Increase the youth development rate of the national minimum wage,** currently 92p/hr lower, to the full adult rate of £5.52/hr. This way employers would compensate some young workers. A substantial increase in the youth NMW could have implications for youth employment however.

- **Single childless workers.** The Chancellor has suggested he will look at compensating people for the 'average losses' from the removal of the 10p tax rate among this group. The average loss here is around £125 per year, but targeting the extra money just at the losers will be difficult, hence compensation will be expensive. His options are:

- **Double the maximum basic Working Tax Credit payment - up by £1,800 per year.** This would compensate almost all losing single childless people over 25 as well as some of the working couples and couples with children who lose. It would be easy to implement from next year but hard to backdate to this year.
- **Treat single childless people the same as childless couples for WTC purposes.** This would raise single childless maximum WTC by £1,800 per year. It would compensate almost all of the around 1 million losers in this group, but average gains would be much higher than the Chancellor has indicated, the cost would be substantial and it would take some time to implement such a change. As in the past, there may also be accusations that the government is providing financial incentives for couples to split up.

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- **Younger women pensioners.** The Chancellor has strongly indicated that he will use the winter fuel payments (WFPs) mechanism to compensate younger women pensioners. The problem here is how well-targeted such a policy would be. His options are:
 - **Increase WFP by £200 per year for low-income pensioners aged 60-64.** This would be cheap and effective, but for discrimination reasons it would be difficult to exclude men of the same age from the same payment.
 - **Increase WFP by £200 per year for low-income men and women aged 60-64.** This would double the cost of the above measure. Furthermore, since WFPs are not means-tested, it will be very difficult to introduce a whole new payments mechanism that takes account of pensioner income in short order. Hence for reasons of speed, the government may have to give all young pensioners the extra £200.
 - **Increase WFP by £200 for all pensioners aged 60-64.** This is the simple option, but poor targeting means that it isn't a very cost effective method of compensating losers.

WORKABLE COMPENSATION PACKAGES

- Best-targeted package that would cover almost all losers is a combination of 2 a), 3 a) and 4 c). Total cost would be around **£5½ bn** per year; ~ 90% coverage. This is clearly way too expensive.
- Targeting only the young workers, single childless and pensioners using 2 a), 3 b) and 4 c) would help all the groups mentioned in the chancellor's letter. Total cost would be **~£2½bn** per year; coverage ~50-60%
- Excluding young workers, the other two groups (60% of losers) could be fully compensated by 3 b) and 4 c). Total cost would be around **£1½bn** per year; ~30% coverage.
- The sub-£1bn option involves: compensating the pensioners fully with option 4 c); increasing WTC for single childless people by some intermediate amount, such as option 3 c), to compensate some losers; and making a gesture to low-paid young workers by raising NMW for 21 year olds, option 2 b). Total cost **£500m- £1bn**; 15-20% coverage.

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10p TAX RATE – OPTIONS FOR COMPENSATING THE LOSERS

Group	Option	Description	Cost	Pros	Cons	Cost per compensated loser	Proportion of losers compensated
1. All losing groups	a) Replace 10p band	Reverse Budget decision	£8.6bn	<ul style="list-style-type: none"> Removes all losers Reasonably simple 	<ul style="list-style-type: none"> Huge cost Reintroduces complexity 	£1,600	100%
	b) Increase personal allowance	Raising personal allowance for everyone by ~£1,100 to compensate all losers. V similar to above.	~8bn	<ul style="list-style-type: none"> Removes all losers Simple 	<ul style="list-style-type: none"> Huge cost Most of the benefit goes to those with highest incomes 	£1,600	100%
2. Young people	a) Extend Working Tax Credit to childless people under 25	~1.5 million employed, childless people under 25 could qualify for tax credits	£900m² Assuming current ~30% take-up rates and average awards	<ul style="list-style-type: none"> Would compensate many losers under 25 	<ul style="list-style-type: none"> Very costly Does nothing for single childless people without children on £13k-£18k 	£600	20-30%
	b) Raise minimum wage for 21 year olds	21 year olds currently receive NMW of £4.60/hr. This option would put them on adult rate of £5.52/hr	No cost to government (small exchequer saving)	<ul style="list-style-type: none"> Would increase incomes of 50k-60k 21 year olds better-off Would satisfy lobby groups' desires to see 21 year olds on adult rate 	<ul style="list-style-type: none"> Only helps 1% of losers Could result in job losses for 21 year olds Employers foot the higher tax bill 	N/A	Less than 1%
	c) Raise minimum wage for 18 to 21 year olds	As above but for 18 to 21 year olds	No cost to government (small exchequer saving)	<ul style="list-style-type: none"> 320,000 young people paid below adult NMW would benefit 	<ul style="list-style-type: none"> Helps only 5% of losers Significant risk to employment chances of younger workers Employers foot the higher tax bill 	N/A	Less than 5%
3. Single people earning between £13,000 and £18,000	a) Raise value of Working tax credit by £35 per week	~3m losers compensated from raising max WTC for all working people by £1,770 per year	£4.4bn	<ul style="list-style-type: none"> Resolves the issue for this key group Poorly-targeted on losers Strengthens work incentives 	<ul style="list-style-type: none"> Reduces incentives to progress in work Arguably a financial incentive to be single 	£1,500	50-60%

² This number has changed from an earlier version to apply a more realistic take-up assumption

	b) Raise childless single tax credit by £35 per week.	~1 million compensated by doubling max WTC for childless single people (£1,770 per year increase). Couples and singles both entitled to same amount of WTC	£1.4bn Assuming current 35% take-up rate and current average awards	<ul style="list-style-type: none"> Resolves the issue for this key group Well-targeted on losers Strengthens work incentives 	<ul style="list-style-type: none"> Reduces incentives to progress in work Arguably a financial incentive to be single Take-up of this help is low, many only theoretically compensated 	£1,400	~20%
	c) Raise childless single tax credit by £10 per week.	~300k potentially compensated by increasing max WTC for childless single people (£500 per year increase).	~£500m Assuming current 35% take-up rate and current average awards	<ul style="list-style-type: none"> Helps those who lose most and the poorest Strengthens work incentives 	<ul style="list-style-type: none"> Doesn't help all losers Take-up of this help is low, many only theoretically compensated 	~£1,700	5-10%
	d) Raise childless single tax credit by £10 per week – higher take-up	As above, but take-up doubles as generosity increases	~£1bn Assumes 70% of cash entitlement taken-up	<ul style="list-style-type: none"> Helps those who lose most and the poorest Actually benefits more losers due to high take-up Strengthens work incentives 	<ul style="list-style-type: none"> Doesn't help all losers 	~£3,000+	5-10%
4. Pensioners aged 60 to 64	a) Extend higher personal allowances to all 60 – 64 year olds	Increase personal allowance by £1,100 for 3.7m people between 60 and 64.	~£1bn	<ul style="list-style-type: none"> Resolves the issue for this group 	<ul style="list-style-type: none"> Helps many winners as well as losers – poorly targeted on losers 	£3,300	6%
	b) £230 more in winter fuel payments for all women aged 60 to 64	1.9 million women (and 1.8 million men) stand to gain. Extra payment could be targeted to meet maximum loss from 10p abolition	£400m (£800m)	<ul style="list-style-type: none"> Reasonably well targeted on this group Resolves the issue for this group 	<ul style="list-style-type: none"> Helps many winners as well as losers – hard to target on losers Discrimination laws mean it would have also to be given to men, doubling cost 	£2,700	6%
	c) £230 more in winter fuel payments for women aged 60 to 64 targeted specifically at those on low incomes	The 300,000 losing pensioners could all be compensated	£60m (£100m-£150m)	<ul style="list-style-type: none"> Very well targeted on this losing Resolves the issue for this group 	<ul style="list-style-type: none"> Administratively complex since winter fuel payments are currently universal Could take some time to implement Not really the purpose of winter fuel payments Difficult to exclude low-income men due to discrimination laws 	£400	6%

Sources: Labour Force Survey; IFS calculations; HMRC tax credits statistics; HMT Tax Ready Reckoner; Low Pay Commission Report 2008