“Think again, Nick!”

Why spending £17 billion to raise tax thresholds would not help the poorest

by Tim Horton and Howard Reed
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Executive summary

This report analyses the Liberal Democrats’ proposal to increase the income tax personal allowance to £10,000 for both working-age individuals and pensioners, combined with a corresponding reduction in the ‘higher rate threshold’.

The stated motivation behind the policy is to “ensure no-one pays a penny of income tax on the first £10,000 they earn, giving tax freedom to millions of working people and pensioners on low incomes”. It has also been billed as “tax cuts for households on low and middle incomes to help people make ends meet” and “a vital step towards delivering real social justice for all”.

But the analysis in this report shows that:

- the measure would do nothing to help the very poorest, who don’t have income large enough to pay tax. Three million households in the poorest quarter of the population – some of those who most need help – would see no gain from the policy (Section 3.1.1);

- far from being focused on helping those on low incomes, increasing the personal allowance is a society-wide tax cut, with most of the proceeds going to the better off. Of the £17 billion total cost, only around £1 billion (6% of the total) actually goes on the stated aim of lifting low-income households out of tax. The remaining £16 billion (94% of the total) goes towards cutting taxes for middle- and higher-income households (Section 3.1.2);

- increasing the personal allowance is regressive, producing higher gains for richer households than for poorer ones. For example, households in the second richest (9th) decile would gain on average four times the amount that those in the poorest (1st) decile would get from this measure (Section 3.1.2);

- the result is that households in the middle of the income distribution see larger proportionate gains in their household income than those at the bottom, increasing socially damaging inequalities between the bottom and middle (including relative poverty) (Section 3.1.3);

- none of these problems are offset by the tax increases the Lib Dems have proposed elsewhere to fund this measure, which are primarily focused on the very richest in society (such as closing loopholes for tax avoidance and a ‘mansion tax’), laudable though these might be (Section 3.1.4); and

- those on low incomes would be much better off if, rather than being ‘lifted out of tax’, the same £17 billion was spent on measures such as tax credits, benefits or key welfare services (Section 3.2.4).
We conclude that the Liberal Democrats’ proposed tax cut fails the fairness test. This report therefore calls upon the Lib Dems to scrap their policy of increasing the personal allowance to £10,000, and instead use the available resources in ways that are fairer and more beneficial to those on low incomes.

GRAPH 1: Average gains per decile (£ / week) to households from the Liberal Democrat proposal, which is to increase the personal allowance to £10,000 combined with a downwards adjustment of the ‘higher rate threshold’. Modelling by Landman Economics

GRAPH 2: The distributional impact (% change in net household income) of the Liberal Democrat proposal, which is to increase the personal allowance to £10,000 combined with a corresponding downwards adjustment of the ‘higher rate threshold’. Modelling by Landman Economics
1) Introduction

In June 2005, in the wake of his General Election defeat, a defiant Michael Howard gave one of his best speeches as Tory leader. He was hitting back at senior Conservative figures, including Maurice Saatchi, who had offered stinging criticism of his election strategy, arguing that Howard should have gone much further on tax cuts. Why had the Tories, Saatchi ranted, not stuck with their proposal to increase the personal allowance?

Howard’s reply was illuminating. “Initially I was extremely attracted to an increase in personal allowances” he said, “until we looked at the practicalities of it. A tax cut along these lines - costing nearly £3bn - would have given the poorest 10 per cent an average change in net weekly income of precisely 7 pence. In contrast, the richest decile would have received nearly £7 more a week…That is why we looked elsewhere” (speech to the Centre for Policy Studies, 27 June 2005).

Earlier that month, Saatchi had received an even more forensic rebuttal from David Willetts, who set out the issue as follows:

“Increasing the threshold cuts the tax bill for everybody. It takes some people out of income tax, but it is worth most to people who are still paying income tax and get the full benefit of the higher threshold. When I asked the Treasury last year how much it would cost to raise the personal tax allowance to £10,000, it estimated the cost at £30 billion. Of this, only about £2 billion was spent on people who are taken out of tax altogether.

“So raising the personal tax allowance costs an awful lot of money,” concluded Willetts, “and it is worth least to people on low incomes who don’t get the full value of the policy…My conclusion is that we should both reform our tax system and help poor people. But these are different problems requiring different solutions” (The Times, 23 June 2005).

These profound Conservative contributions to the politics of tax fairness seem a million miles away from 2010, where David Cameron is committed to a regressive increase the tax allowance for married couples, and George Osborne promises to slash inheritance tax for millionaires. Among other things, it dispels the notion that the last four years have somehow been about a Conservative shift to the centre. On tax, at least, the reality is a significant shift to the right.

But perhaps an even bigger disjunction between that post-2005 era and now is that the same idea rejected by Michael Howard as too unfair has now been resurrected and is being strongly advocated, not by the Taxpayers’ Alliance or UK Independence Party, but by the Liberal Democrats.

And it has been resurrected, moreover, under the banner of ‘tax fairness’.

What is going on?
2) The Liberal Democrats’ proposal

The Liberal Democrats’ headline tax proposal is to increase the income tax personal allowance to £10,000 for working-age individuals and pensioners.¹ This involves increasing the personal allowance for working-age individuals from its current level of £6,475 to £10,000 (an increase of £3,525), from £9,490 to £10,000 for those between 65 and 74 (an increase of £510), and from £9,640 to £10,000 for those over 75 (i.e. an increase of £360).

The Lib Dems estimate the cost of this policy at £16.5 billion.² Because the personal allowance for pensioners is already quite close to £10,000, and because there are much larger numbers of working-age individuals than pensioners, the vast majority of the cost of this policy is spent on increasing the personal allowance for those of working age.

A simple increase in the personal allowance would push up the point at which people start paying the higher (40%) rate of tax. This is because the width of the basic rate ‘taxable band’ remains the same, while the income level at which the basic rate starts to apply has been moved upwards, thereby also moving upwards the point at which higher rate starts to apply. For this reason, proposals to increase the personal allowance by a certain amount often come with a further commitment to reduce the width of the basic rate taxable band by the same amount, so that the higher rate ‘kicks in’ at the same point as it did before. (Throughout the report we will refer to this as a downwards adjustment of the ‘higher rate threshold’.)

Our understanding is that the Liberal Democrats are indeed intending to make such a downwards adjustment of the higher rate threshold as part of their proposal.³ For working-age people, this would entail increasing the personal allowance from £6,475 to £10,000 (an increase of £3,525), and simultaneously reducing the size of the basic rate taxable band from £37,400 down to £33,875 (a reduction of £3,525), thereby ensuring the higher rate still kicks in for income above £43,875.

This report illustrates modelling of the Liberal Democrat proposal across households, calculated by Landman Economics. In the Appendix to this report, we also give analysis for a simple proposal to increase the personal allowance to £10,000, without the corresponding downwards adjustment of the higher rate threshold, to illustrate the difference that such an adjustment makes.

¹ This proposal was announced in April 2009 and became official party policy at their September 2009 annual conference. It replaces an earlier radical proposal from the Liberal Democrats for a 4p cut in the basic rate of income tax – which was initially introduced under Ming Campbell, and then continued into the early stages of Nick Clegg’s leadership. (An increase in the personal allowance to £10,000 has been considered by the Liberal Democrats before, most recently in 1998, when it was floated during Paddy Ashdown’s tenure as leader. Under Charles Kennedy’s leadership, this proposal then fell off the radar as Liberal Democrat policy moved in a somewhat different direction.)

² This is of course less than the £30 billion estimate given in the quotation from David Willetts in the Introduction, mainly because the income tax personal allowance is now much closer to £10,000 than it was in 2005 (£6,475 now, compared to £4,895 in 2005).

³ Personal communication, Lib Dem press office.
The Liberal Democrats propose to pay for this measure through a range of tax increases elsewhere. Among these are measures to close tax loopholes and cut reliefs that benefit the wealthiest, such as restricting pensions tax relief to the basic rate (saving £4.6 billion) and aligning rates of capital gains tax and income tax to close down a common avoidance route (raising £3.2 billion), as well as a broader package of anti-avoidance measures (saving £4.7 billion), and a ‘mansion tax’ on properties worth over £2 million (raising £1.7 billion). The lion’s share of this revenue would therefore seem to be raised from the very wealthy and those with very high incomes. A further revenue-raising package comes from measures to increase taxes on air travel.\(^4\)

The aim of this report is not to try and evaluate this whole set of tax proposals. At certain points below, especially when making overall assessments of things like progressivity and ‘fairness’, the analysis attempts to discuss the cumulative effects of this whole package.

But it is worth emphasising that, for the most part, this report is concerned to evaluate the Lib Dems’ proposal to increase the personal allowance to £10,000 on its own terms.

This is not simply because a decision about how to spend revenue is to some extent independent of how that revenue is raised – and so can be judged separately, especially when that policy is worth £17 billion. (It is worth putting on the record here that we support some of the Lib Dems’ very good proposals to ask the super-rich to pay more in taxation. But that should not translate into support for their whole tax package if its overall effect would still be unfair.)

A more important reason is that the Liberal Democrats themselves have argued that raising the personal allowance is right in itself, and they are making it an important symbol of their political agenda.

The stated motivation behind the policy is to ensure that “people on low incomes no longer have to pay any income tax” (Liberal Democrat Tax Plans). As Nick Clegg put it recently, increasing the personal allowance “will ensure no-one pays a penny of income tax on the first £10,000 they earn, giving tax freedom to millions of working people and pensioners on low incomes” (Nick Clegg, speech, 1 Feb 2010). The proposal is also usually advocated alongside claims that it is wrong for people on low incomes to be paying income tax in the first place.

As such, the Liberal Democrats argue their proposal to increase the personal allowance would deliver a fairer tax system: “fairness should be hardwired into…the tax system, by introducing a £10,000 tax-free allowance for everyone” (Nick Clegg, Independent, 25 February), and this would be “a vital step towards delivering real social justice for all” (Nick Clegg, speech, 1 Feb 2010).

\(^4\) For further details, see Liberal Democrat Tax Plans, available at the Liberal Democrats’ website.
This report analyses the Lib Dems’ headline tax proposal to see if these claims are substantiated. Is it really a good use of £17 billion? And does the decision to spend available revenue on raising the personal allowance to £10,000 entitle you to claim the mantle of ‘tax fairness’?
3) What’s wrong with spending £17 billion to raise tax thresholds?

It sounds so simple and obvious: help the poorest by cutting their income tax. What could be more elegant or fairer than raising tax thresholds to ‘lift the poorest out of tax altogether’? What could be more of a travesty than people on low incomes having to give some of it up to the Exchequer?

If only it were that simple. In this section we look at why there might be much more to this policy than at first meets the eye, and why something that sounds fair on first consideration actually turns out to be quite an unfair use of resources.

3.1 A regressive policy

3.1.1 Ignoring the poorest

The first reason why increasing tax thresholds is not progressive is that it excludes the poorest from help altogether.

This is because it can only benefit those earning enough to pay tax. Yet many individuals and households in the UK have annual income less than the income tax threshold of £6,475.

In 2009, for example, a quarter of the four million part-time jobs done by women paid than less than £5,400 a year. Half paid less than £8,600.\(^5\) One can well imagine a parent juggling some part-time work with caring for their children whose earned income falls beneath the tax threshold.

Added to the low paid are many individuals out of work, whether unemployed, sick or single parents looking after young children. And then there’s a sizeable number of struggling pensioners. Many of these individuals and their households will have income less than the personal allowance.

Analysis of the Liberal Democrat tax proposal shows that some 3 million households in the poorest quarter of the household income distribution would not benefit.

Arguably, some of those groups that most need help in our society are not helped by this measure.

3.1.2 Giving less to poorer households and more to richer households

Many who advocate raising tax thresholds describe and justify the policy as if it were specially directed towards helping low-income households.

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\(^5\) Annual Survey of Hours and Earnings, 2009, Office for National Statistics. Figures for female part-time employee jobs, United Kingdom.
The Liberal Democrats have described the plan as “tax cuts for households on low and middle incomes to help people make ends meet,” adding that, “focusing our tax cuts on these groups will have the strongest economic effect” (Liberal Democrats Fairer Future Economic Recovery Plan, May 2009, p.4).

But, of course, raising tax thresholds isn’t focused on struggling families, and doesn’t just ‘lift those on low incomes out of tax’; it cuts tax for everyone else too (since they all benefit from a higher threshold). So in evaluating whether or not it is a fair use of resources, we should look at its impact across all households.

Analysis in this section shows that increasing the personal allowance would be a regressive use of resources – giving more to richer households and less to poorer households. Beyond the exclusion of the very poorest, discussed above, there are various reasons why trying to help families by increasing the personal allowance turns about to be regressive.

One such reason is that the amount gained from increasing the personal allowance is to some extent dependent on the size of an individual’s existing tax liability. Even for those with incomes higher than the tax threshold (£6,475), an increase in the allowance to £10,000 would be of less benefit to those earning under £10,000 than to those earning more than £10,000. This is because those earning under £10,000 will only benefit from part of the threshold increase. Once your tax liability has been reduced to zero, you cannot benefit from a further increase in the allowance. An illustration is given in the box below.

**Box 1: How the value of increasing the allowance depends on the size of your tax liability**

Angela earns £8,000. Under the current system, she pays no tax on the first £6,475. She then pays 20% on the remainder of her income up to £8,000 – that is, on some £1,525 worth of income. If the personal allowance is now increased to £10,000, she now pays no tax on her £8,000 of income. So the £3,525 increase in the personal allowance has reduced the amount of income on which she pays the basic rate of tax by £1,525, saving her £305 a year (20% of £1,525) or £5.87 a week.

Beth earns £10,000. Under the current system, she pays no tax on the first £6,475. She then pays 20% on the remainder of her income up to £10,000 – that is, on some £3,525 worth of income. If the personal allowance is now increased to £10,000, she now pays no tax on her £10,000 of income. So the £3,525 increase in the personal allowance has reduced the amount of income on which she pays the basic rate of tax by £3,525, saving her £705 a year (20% of £3,525) or £13.56 a week.

Another potential issue with the Lib Dem proposal is that, because the measure helps people through the tax system (which is individualised), richer households with two earners will gain more than poorer households with one or no earners.6

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6 A third problem sometimes associated with proposals to increase the personal allowance is that, if you do not make a corresponding downwards adjustment to the higher rate threshold, then higher-rate payers gain by twice the amount that basic-rate payers do (since all the thresholds are ‘pushed’ upwards and income is
The graph below shows the average weekly gain from the Liberal Democrat proposal for each household income decile (that is, each tenth of households lined up from poorest to richest, where ‘1’ = the poorest tenth and ‘10’ = the richest tenth). As can be seen, the gains become progressively greater as you move up the income spectrum from poorest to richest. For those in the 6th decile, the average gain (£14.97 a week) is nearly three times that for the poorest decile (£4.84). For those in the 9th decile, the average gain (£19.35) is four times that for the poorest.

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<th>household income decile</th>
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GRAPH 3: Average gains per decile (£ / week) to households from the Liberal Democrat proposal, which is to increase the personal allowance to £10,000 combined with a downwards adjustment of the ‘higher rate threshold’. Modelling by Landman Economics

Our modelling suggests that the total cost of this policy (including savings from means-tested benefits) would be £17.8 billion (a little more than the Liberal Democrat estimate of £16.5 billion).

Around 70% of this goes to the richer half of society, while just 30% goes to the poorer half.

Indeed, while the key motivation often cited for the Lib Dem proposal is to ensure that “people on low incomes no longer have to pay any income tax” (Liberal Democrat Tax Plans, 30 November 2009), our modelling suggests that, of the £17.8 billion cost of the policy, only around £1 billion (6% of the total cost) is actually spent lifting people on low incomes out of income tax. The remaining £16.8 billion (94% of the total) is spent cutting taxes for middle- and higher-income households.

then relieved from tax at your marginal rate, that is, 40% for higher-rate payers). This is not an issue for the Lib Dem proposal, however, which does include a downwards adjustment to the higher rate threshold. We discuss this issue further in Appendix 1.
What are the consequences of increasing the personal allowance for the distribution of income? The conventional way of assessing the distributional impact of a policy is to look at the percentage change in net household income experienced as a result. The graph below illustrates the impact of the Liberal Democrat proposal by household income decile.

As can be seen, the proportionate gain that households experience from raising the personal allowance to £10,000 gradually increases as you move up the income distribution, falling away a little in the 9th decile and more significantly in the 10th decile. (This is because, even though households in these deciles receive bigger cash gains on average than those in all other deciles, their household incomes are so much greater that the proportionate impact is slightly less.) Nevertheless, on balance the overall impact is regressive, with those in the lower deciles getting smaller proportionate gains than all except the 10th decile.

3.1.3 Increasing the gap between the bottom and the middle

These conclusions have an important implication: raising the personal allowance increases inequality between the bottom and the middle of the income distribution.

Because the policy would increase the incomes of those in the middle by more (proportionate to household income) than it would for those at the bottom, the result is that low-income households would fall behind relative to those in the middle. As the
graph above shows, households in the 5th and 6th deciles (where the median is) have their income increased on average by 3%, whereas households in the first and second deciles (the poorest) have their incomes increased by only 1.6%.

In welfare terms, the gap between the bottom and the middle is a very significant inequality (arguably more significant than that between middle and top), since the ability of the poorest to participate in society is in important ways determined by how close or distant their household income is from those in the middle.

The standard definition of relative poverty, for example, is to fall beneath 60 per cent of median household income, though other measures are sometimes used, such as 50 per cent of median income, or 50 per cent of mean income. All of these types of inequality would be increased by the Liberal Democrat proposal, with detrimental consequences for the welfare and social inclusion of low-income households.

3.1.4 Do proposed tax rises elsewhere mitigate these effects?

Proponents of raising the personal allowance often point out that the measure can be made less regressive if combined with tax rises elsewhere. And, of course, this increase in the personal allowance is not the only aspect of the Liberal Democrats’ tax proposals.

As argued above, different components of the Lib Dems’ tax package can (and to some extent should) be evaluated separately. There is nothing about any of the Lib Dems’ tax-raising proposals that then compels them to raise the personal allowance to £10,000. Especially when a policy costs £17 billion, it is right that it should be judged on its own merits.

However, as the proposal to increase the personal allowance is part of a broader package, it is worth thinking what the cumulative impact of this would be.

As discussed earlier, the lion’s share of the revenue raised from the Lib Dem’s proposed tax increases would seem to come from the very wealthy and those with very high incomes. So let us for the moment assume that the revenue to pay for the proposed increase in the personal allowance comes solely from those in the top decile.7

What would the distributional impact of this combined package then look like? For the first nine deciles (from poorest up to second richest), the impact would be the same as that shown in the graphs above; the difference would be for the richest decile, which would now have a significant net loss of household income (since they are funding the whole package).

7 The Liberal Democrats have themselves encouraged this interpretation: for example, “We will close loopholes for the richest and introduce a tax on mansions to fund tax cuts of £700 for everyone else” (Liberal Democrat news release, 11 Jan 2010), so this seems a reasonable simplification to make for assessing the policy. (In reality, some of the proposed tax increases, like increased taxes on air travel, would fall across the population as a whole.)
Many will support measures that ask the richest in our society to pay a larger share of their income and wealth in taxes.

But is the *overall impact* of this package of reforms fair? Is it ‘progressive’?

It seems hard to claim that it is, since the regressive gradient of gains across the rest of the population still remains.

So, even when these various tax plans are looked at in combination, the Lib Dem tax package does not deal with the three central concerns outlined above:

• those with incomes below £6,475 get nothing;
• the package is regressive, giving more to richer households than to poorer ones; and
• the package would increase income inequality between the bottom and the middle, increasing social exclusion.

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Many plans to ‘help the poorest’ by increasing tax thresholds often end up scrabbling around looking for compensating measures to try and make the impact of the policy less regressive. Note the real incongruity between the rhetoric of advocating an increase in the personal allowance as a vital measure of social justice, on the one hand, and the arguments that its distributional impact can be made less unfair in tandem with tax increases elsewhere, on the other.

It rather raises the question: why go down the route of increasing the personal allowance in the first place? Why not help people on low incomes in other ways?

### 3.2 Missing what matters for people's welfare

In addition to the Liberal Democrats’ proposal, an increase in the personal allowance has been advocated at various points over the last decade, mainly by those on the Conservative right such as Maurice Saatchi or Norman Blackwell.

Both the Lib Dems and these Conservative figures base their criticism of the tax system on assumptions about tax and welfare that are open to question – and it is these assumptions that we examine here.

The implicit claim made by those who call for people on low incomes to be ‘taken out of income tax’ is that the payment of income tax is somehow the *cause of* low disposable incomes (and the associated hardship), and that everything would be OK if only they
were taken out of tax. For example, right-wing commentator James Bartholomew, in *The Welfare State We’re In*, makes the claim that, “High taxation is a major part of what is wrong with the welfare state. It has made people – including those on average incomes and below – a great deal poorer than they otherwise would have been” (2004, p.325).

Similarly, Nick Clegg has argued that: “The tax system does redistribute power, but it does it in the wrong way: it sucks the poorest dry, weakening them still further…” (The Liberal Moment, 17 September 2009). And a recent Liberal Democrat policy document argues, “millions of people on low incomes are forced to pay hundreds of pounds in income tax every year, keeping pensioners on the bread line…” (*Liberal Democrat Tax Plans*).

But this claim is bogus, and the analytical framework behind it wrongheaded.

### 3.2.1 The importance of benefits and public services

The first and perhaps obvious point is that it is ridiculous to look at the impact of tax in isolation. Tax pays for stuff that benefits people – including direct cash transfers to support households. Ignoring these produces a meaningless measure of household welfare.

That is why, while there are several different measures of household welfare, all attempt to look at households’ net financial position in some way – taking into account the benefits they receive as well as the taxes they pay.

The standard notion of income used for assessing poverty levels, for example, is *disposable* income (or, more technically, ‘net disposable equivalised household income’), which includes a consideration of not only the direct taxes people pay (like income tax, National Insurance and council tax), but also the benefits and tax credits they receive (like the Basic State Pension, Housing Benefit, the Child Tax Credit, free school meals, and so on).

Another important concept is *final income*. This – crucially – takes into account the value of public services people receive, and also the indirect taxes people pay (like VAT, duties, and so on).

The diagram below shows the important components of this cycle of taxation and spending: the payment of direct taxes; the receipt of cash benefits and tax credits; the payment of indirect taxes; and the consumption of public services.
It should be clear that it is slightly meaningless to discuss the fairness or otherwise of particular levels of taxation on people without also taking into account why they pay it and what they get for it in return. If you only consider ‘pre-welfare income’, there is no welfare difference, for example, between a society in which someone pays £50 a week in tax and gets no benefits and one in which the same person pays £50 a week in tax and gets £100 in benefits – a ridiculous conclusion.

Yet that is the logic of many of the arguments put forward by the ‘take-people-out-of-tax’ school.

To take an example more relevant to our considerations here, many advocates of the ‘take-people-out-of-tax’ school imply they would prefer a society in which someone pays £0 a week in tax and gets no benefits to one in which the same person pays £50 a week in tax and gets £100 in benefits.

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8 Note that this analysis differs slightly from the standard analysis of household income – which is conceptually more accurate than this one – in a couple of important ways. In order to correspond more closely to the political analysis of those advocating an increase in the personal allowance (and the way people think about tax more generally), we have indicated the payment of direct taxes as prior to the receipt of benefits, even though in the real world benefit entitlements are added to original incomes (to produce gross incomes) before tax liabilities are calculated. (This is because some benefits are counted as taxable income.) This is also why the receipt of benefits is described as ‘net benefits’ – indicating the amount received when you take into account that some of these benefits would have been taxed away. Furthermore, the final stage indicates the value received from ‘public services’, which is a broader concept than that of ‘benefits in kind’, traditionally used by the Office for National Statistics in its welfare calculations.
The reason that many right-wingers often end up in this indefensible position is that their primary concern isn’t ‘welfare’ in terms of outcomes from the tax and benefits system, but rather an opposition to the fact that people have to pay tax at all. Their concern with ‘welfare’ is instead focused on the fact that individuals are subject to ‘coercive taxation’ or in receipt of benefits and services (which they call ‘welfare dependency’), issues that they rank more importantly than actual outcomes. As Maurice Saatchi put it, “A War of Independence is just because dependence is bad and independence is good – good in itself…it should be fought first to rescue [millions on low incomes] from tax payments that help to make them dependent on government” (2001, p.3)
£3,100 in indirect taxes), but as part of a system that then gives them £6,453 on average in cash benefits and £7,494 in key welfare services (like health and education) – significantly improving their welfare.

The result is that the system of tax and spending is a significant driver of greater equality. Even only taking into account the limited expenditure analysed by the Office of National Statistics\(^\text{10}\), very roughly the system turns an initial inequality in market incomes between the top fifth and the bottom fifth of around 16-to-1 into a final inequality in incomes between the top fifth and the bottom fifth of around 4-to-1.

Sometimes right-wing critics of the welfare system paint it as ‘taking money from people with one hand and giving it back with the other’. The reality is much more complex, but obviously includes, as we see here, redistributing resources from richer individuals and households to poorer ones.

3.2.3 Considering the net effect of tax cuts

It would therefore be wrong to assume that it necessarily harms the welfare of those on low incomes for resources to pass through this redistributive system of tax and spending.

Provided the taxes those on low incomes are paying are progressive taxes that are also paid by others, and provided the proceeds are then invested in the system of benefits and public services, *those on low incomes are significantly better off as a result of paying those taxes than they would be from being ‘lifted out of them’ if that also then meant no-one else paying them and public spending being cut by the corresponding amount.*

And this is something that proponents of ‘lifting the poorest out of tax’ miss.

As we saw earlier, increasing the personal allowance cuts taxes across society. In the context of the Lib Dem proposal, only £1 billion of the £17.8 billion cost actually went towards ‘lifting those on low incomes out of tax’; the remaining £16.8 billion was a massive tax cut for everyone else. Imagine now a ‘revenue-neutral’ tax cut where the personal allowance is increased to £10,000 and public spending is reduced proportionately across all benefits and services by the £17.8 billion that this measure would cost. Given that the poorest households benefit disproportionately from spending on benefits and services, it is highly likely that the amount they would lose from this spending reduction would be more than they would gain from being ‘lifted out of tax’.

The result is that, when you take the whole cycle of tax and spending into account, those on low incomes would actually be *net losers* from a revenue-neutral tax cut that ‘lifted them out of tax’ by raising the personal allowance to £10,000 and reducing public spending accordingly. (These issues are analysed in more detail in Reed and Horton, forthcoming.)

\(^{10}\) Personal taxes (direct and indirect) account for only around 60\% of all taxation; cash benefits and ‘benefits in kind’ account for only around half of all public spending.
It should be emphasised that the Liberal Democrat proposal is not that their proposed increase in the personal allowance should be paid for by cuts in public spending; rather, they propose to finance it by increasing a range of other taxes (especially on richer households) and closing avoidance loopholes.

However, the analysis here still informs a related criticism of the Lib Dem proposal: those on lower incomes would be vastly better off if this £17 billion in question was spent in other ways.

### 3.2.4 The wrong priorities? More equitable ways to use resources

As the distributional analysis earlier demonstrated, if your aim is to help those on lower incomes, raising the personal allowance is a very ineffective use of £17 billion. Three million households in the poorest quarter of the population see no benefit whatsoever, while the average gain for households in the poorest decile is just £4.84 a week, compared to £18 or £19 a week on average for those at the top of the income distribution.

In fact, these regressive effects are simply the natural consequences of trying to cut progressive taxes using the underlying ‘parameters’ of the tax system – rates and thresholds.

Nick Clegg has recently argued that “returning money to people who need it is fair, liberal, and right” (conference speech, 17 September 2008). Fine, but you don’t have to do this by cutting taxes. If you want to help families on low incomes, there are plenty of other options. Here we look at three: fairer cuts in direct taxation; cuts in indirect taxation and spending on benefits and public services.

#### 3.2.4.1 Fairer cuts in direct taxation

Even if your sole objective was to reduce the tax liabilities of those on low incomes, there are much fairer ways to do it than increasing the personal allowance.

One option would be to cut taxes by an externally-defined lump sum (defined, that is, without reference to existing parameters of the tax system such as rates and thresholds). This would give everyone the same size tax cut. In a recent book, *The Solidarity Society* (Horton and Gregory, 2009), we argued for the introduction of a flat-rate *universal tax credit* – a mechanism within the tax system that could reduces taxes for all by the same amount.

An even more progressive way to cut taxes would be to give larger tax cuts to those on lower incomes than to those on higher incomes. Thankfully, there is a mechanism that already does this: tax credits. Because the size of the tax credit is progressively tapered, its value for those on lower incomes is higher than for those on higher incomes. Tax
credits are, if you want, ‘progressive tax cuts’ – compared to the Liberal Democrat proposal, which is a regressive tax cut. And a further advantage of tax credits is that they are ‘payable’ (refundable), so that if you have no tax liability you can claim your award as a net payment; so, unlike the Liberal Democrat proposal, they do not ignore the poorest.

Earlier it was argued that it is nonsensical simply to look at whether or not someone is paying tax or not in order to evaluate their welfare: one has to consider how the whole system of tax and spending affects them. But if you do feel offended by the idea of people on low incomes contributing to the Exchequer, then you should like tax credits very much indeed. Because they are targeted disproportionately on low-income households, tax credits end up stopping far more households being net contributors to the Exchequer than equivalent-costing increases in the personal allowance would.\(^\text{11}\)

3.2.4.2 What about the effect of indirect taxes?

A key criticism of the current tax system from those advocating the Liberal Democrat proposal is that the poorest fifth of society pay the highest share of their gross incomes in tax of anyone.

As discussed earlier, judgement is best made about the fairness or otherwise of tax burdens alongside as assessment of how the resources are subsequently used and distributed.

But, on the face of it, the poorest paying the largest amount of their income in tax does seem a strange state of affairs – and certainly so for any tax system claiming to be progressive.

Why does it happen?

The graph below shows the percentage of gross income paid in taxes by each decile.

\(^{11}\) As Gordon Brown put it in his 2005 budget speech, “I could use resources available to me to raise the personal allowance by even more than inflation. But using £1 billion to raise the personal allowance would give a family in work on median earnings with two children just 80 pence a week or £40 a year. But using the same resources to raise the child tax credit will give that same family £5 a week - or £260 a year. So the best way to do most to help low and middle income families is not through a further rise in personal tax allowances but through tax credits.” (Gordon Brown, budget speech, 16 March 2005)
As can be seen, the proportion paid is essentially flat across the top nine deciles (deciles 2-5 pay around 32-33% of gross income in taxes; deciles 6-10 pay around 34-35%). The problem identified by critics of the tax system lies at the bottom decile, which pays 48% of gross income in taxes.

The graph also decomposes these tax burdens into their respective components of direct and indirect taxes. (Here, direct taxes are income tax, National Insurance and Council Tax, while indirect taxes are taxes like VAT, duties and licenses.)

What this decomposition shows is that the exceptionally high percentage of gross income paid in taxes by the poorest decile arises from the disproportionately large burden of indirect taxes on this decile. This is mainly because poorer households have higher spending relative to their income than richer households do; so the taxes paid as a result of this consumption will be a larger proportion of household income for poorer households than for richer households.

The graph shows that the impact of direct taxes is progressive, while the impact of indirect taxes is deeply regressive. So direct taxes work to mitigate the unfair effect of the tax system highlighted above (the poorest paying the highest share of their income in taxes), while indirect taxes only serve to strengthen this effect.

It follows that if you are serious about tackling this unfairness, you do not want to cut direct taxes, as the Lib Dems suggest, but indirect taxes.

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12 Indeed, even if the direct tax burden on the lowest decile were completely eliminated, these households would still pay a higher percentage of gross income in taxes than any other decile because they are currently paying 36% of gross income in indirect taxes.
Indeed, because increasing the personal allowance benefits middle- and higher-income households proportionately more than lower-income households, the effect of the Lib Dem proposal would be to increase this differential between what the poorest pay and everyone else pays.

So cuts in indirect taxation should be considered as another fairer alternative – for example, cuts in VAT.

It is a strange yet perennial aspect of tax debates that the outrage commonly expressed about the tax burden on low-income households rarely leads the protagonists to propose doing anything about the taxes that are actually responsible for this disproportionate burden: indirect taxes. Instead, that outrage is often used, perversely, to argue for tax cuts that would benefit those on higher incomes more, and that would further exacerbate the disproportionality in the burden of taxation between low-income households and everyone else.

3.2.4.3 Spending on benefits and services

Another fairer alternative would be to spend these resources on benefits or public services; as the analysis above showed, both of these can be of particular benefit to low-income households.

One suggestion for redirecting these resources would be through the Lib Dems’ own very good proposal for a ‘pupil premium’ – an extension of current ‘disadvantage-related’ funding for school pupils (one that may also involve some restructuring of funding streams).

Currently, the Lib Dems propose to spend an extra £2.5 billion on the pupil premium. This is a laudable plan, though some have questioned whether it is enough to bring about a significant change in educational outcomes over and above the disadvantage-related funding that the Government is already putting in. A recent evaluation of the Lib Dems’ pupil premium by the Institute for Fiscal Studies concluded that its impact on disadvantaged children was likely to be “positive but small”, and that, to have a more significant effect, “the pupil premium would need to be very large indeed”. Similarly, Tim Leunig of the London School of Economics, examining research from the US, has argued that an effective pupil premium would have to be of a whole different order of magnitude to give disadvantaged pupils more equal chances with everyone else – possibly tens of billions of pounds (as a conservative estimate, he suggests £24 billion).

None of which, of course, means that a £2.5 billion pupil premium is a bad idea.

But it is indefensible to then spend £17 billion on a regressive tax cut.

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The Lib Dems should therefore scrap their proposal to raise the personal allowance to £10,000 and replace it with a fairer alternative – in particular, one that helps low-income households more.

Here, we have given three possible options to use this £17 billion in a fairer way.

- Put the money instead into the tax credit system, which is a far more progressive way of distributing resources. For the same amount of resources, you can help low-income household far more effectively by spending them on tax credits than you can by spending them on increasing the personal allowance.

- Put the money instead into cutting indirect taxes like VAT.

- Put the money instead into key welfare services, for example, an expanded version of the Liberal Democrats' own ‘pupil premium’, raising expenditure on this from the proposed £2.5 billion up to £19 billion – a level at which extra resources could begin to make a real difference.

Many other alternatives are possible.

### 3.3 Social division or integration in the tax and benefits system?

To finish, it is worth considering a deeper aspect of this issue of where tax thresholds should be set – and how the tax and benefit systems interact as a result.

The arguments above have been arguments about distribution. Right-wing claims about the welfare consequences of those on low incomes paying income tax conveniently forget about the impact of benefits and public services, as well as the fact that, taken together, the system of tax and spending disproportionately benefits those on low incomes. That is why they get the distributional arguments wrong.

But it is also worth asking if there are any other grounds for believing that the political agenda behind calls for people to be ‘lifted out of tax’ might not actually be in the interests of low-income groups in the long run.

Imagine two welfare systems with equal distributive outcomes. In the first, those on low incomes pay no taxes and get a small amount of benefits (£20 a week); in the second, those on low incomes pay some taxes (£50 a week) and get a lot of benefits (£70 a week). In both cases, the net gain to those on low incomes is £20.
Are there nevertheless reasons why we might prefer one type of arrangement to the other?

Many would say that the overlap of tax and benefits in the second case is an undesirable feature of welfare systems, causing complexity and requiring increased administration. And, of course, these are important points that have to be weighed up against others in considering this issue.

But it is possible to take a different view: namely that, provided the distributive outcomes are no worse for low-income households as a result, the overlap of tax and benefits can be socially desirable if this overlap emerges from people at all levels of society participating in the same systems.

Specifically, one concern about the “take poor people out of tax” school of thought is that embedded in it is a view about the ‘exceptionalism’ of those on low incomes. They are viewed as different to the rest of us; the underlying motivation is a benevolent paternalism that seeks to protect the poorest by separating them from the majority outside of the tax system.  

But the vision behind such thinking is one of welfare ‘residualism’, with one set of special arrangements for “the poor” and another set of arrangements for everyone else. By contrast, an alternative vision is one of universalism, or welfare ‘inclusion’, where all participate in the same institutions; here, welfare isn’t about ‘poor people’, but security for all of us.

This is ultimately a point, then, about the way in which welfare institutions structure the social relations between individuals and groups in society. A review of this issue is beyond the scope of this report (see Horton and Gregory, 2009, The Solidarity Society, Fabian Society, for a detailed discussion), but – as the different fortunes of social housing and the NHS perhaps illustrate – there are good reasons for thinking that institutions which separate the poorest off from mainstream society and classify them as different will ultimately serve their interests worse over the long run than institutions which characterise the poorest as fully paid-up members of society and which bind the fortunes of the poorest together with everyone else.

This might sound an abstract argument, but international evidence supports it. Those countries with a significant degree of tax and benefit integration, and where there is a considerable amount of overlap between taxes and benefits, tend to have much more generous welfare states and much lower levels of poverty than those countries that try to help people by cutting taxes.

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15 For example, Maurice Saatchi: “The bottom two deciles should have nothing to do with the income tax system. Likewise, the upper half of earners should have little contact with the benefit system…” (Poor People! Stop Paying Tax!, 2001, p.11).

16 Again, Saatchi: “the ultimate aim [is] that people will either be taxpayers, or benefit recipients, but not both at the same time” (ibid., 2001, p.ii).
One possible measure of tax and benefit integration is the amount of direct taxes paid on welfare transfers: those countries with a high degree of integration tend to rely on transfers for assisting people, which in turn tend to be quite heavily taxed. For example, in recent years, direct taxes paid on welfare transfers have amounted to over four per cent of GDP in Sweden and Denmark, but less than one per cent of GDP in the US.

A second (and opposite) measure is the amount of tax breaks granted for welfare purposes: those countries with a high volume of such tax breaks are trying to help people by reducing tax bills, rather than transfers. For example, in recent years, the US has provided ‘tax breaks for social purposes’ worth more than two per cent of GDP, whereas they are virtually non-existent in Sweden and Denmark.17

On the logic of the ‘take people out of tax’ school, then, the US must be a very good place to be on a low income, whereas Sweden and Denmark must be awful. The US must have done really well at tackling poverty, while Sweden and Denmark must languish at the bottom of the pack. But, of course, it isn’t like that in reality.

Ultimately, it boils down to how you view tax. And while 95% of utterances about tax are probably not happy ones, there is a more positive way in which tax figures in popular conversation: the insistence that “I pay my taxes”. Ultimately, paying taxes and contributing to the collective pot are about membership of society as well as raising revenue.18 Countries which view those on low incomes as fully paid-up members of society, just the same as everyone else, will ultimately evolve welfare states and tax systems that serve their interests far better than countries which don’t.19

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17 The comparative welfare statistics in this section come from Benefits and wages: OECD Indicators, 2007, OECD.  
18 I think this aspect of tax is what Nick Clegg had in mind when he said elsewhere that a positive vision for how to handle immigration was to offer people “a route towards becoming productive, tax-paying members of British society” (Nick Clegg, Independent, 17 September 2007).  
19 James Bartholomew is quite wrong, for example, when he says “there is one aspect of modern taxation that would have scandalised every one of the original creators of the welfare state…Poor people are now taxed” (The Welfare State We’re In, 2004, p.323). William Beveridge, for one, knew full well the importance of workers being seen to contribute towards their benefits, which is why his insurance system demanded a contribution from low-income workers too (though he took this too far by deciding on a flat-rate contribution rate).
4) Commentary and conclusions

Our conclusion is that the Liberal Democrats’ proposed tax cut fails the fairness test.

Spending £17 billion on increasing the personal allowance is a very poor way to help those on low incomes. It could actually harm the welfare of low-income households by increasing inequality and relative poverty. And there are much fairer ways to spend the money. In short, it is neither the best use of the resources nor a policy which achieves its central aim.

Specifically, we found that this tax cut would do nothing for the very poorest, who don’t have enough income to pay tax. We also found that the lion’s share of the money goes to the higher-income households, with low-income households seeing the smallest gains. The impact of the policy would be regressive across the population as a whole. And those on low incomes would be vastly better off if the money were spent in other ways, such as on tax credits or public services.

What about the Lib Dems’ overall package of tax proposals? Certainly, measures that ask those at the very top to pay a higher share of their income and wealth in tax are welcome, and would bring about an important element of redistribution away from the super-rich. But this element of redistribution does nothing to eliminate the deep unfairness of this £17 billion tax cut, which would substantially increase inequality between the bottom and the middle.

It’s perhaps no surprise that the most enthusiastic public cheerleaders for the Lib Dems’ proposed tax cut have not been anti-poverty charities, but Normal Tebbit and right-wing blogger Paul Staines (aka Guido Fawkes).

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In recent times, the Liberal Democrats have used this tax pledge to ground broader claims to be the party of tax fairness: “Only the Liberal Democrats will make taxes permanently fair” (Nick Clegg, speech, 11 Jan 2010), we are told, while the current tax system means that “Labour has no basis on which to claim the ground of fairness any longer” (Nick Clegg, Independent, 25 February).

How does this claim look in light of the analysis here?

The two graphs below compare the distributional impact of the Liberal Democrats’ proposed tax cut, as given earlier, with the impact of Labour’s personal tax and benefit reforms since 1997 (taken from Hills, J., Sefton, T. and Stewart, K. (eds.), Towards a More Equal Society?, 2009).

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20 For Tebbit’s views, for example, see: http://blogs.telegraph.co.uk/news/normantebbit/100022127/why-wont-the-two-main-parties-do-anything-about-the-madness-of-taxing-the-poor/
"Think Again, Nick!"

GRAPH 6: The distributional impact of the Liberal Democrat proposal to increase the personal allowance to £10,000, combined with a corresponding downwards adjustment of the ‘higher rate threshold’. Modelling by Landman Economics


(Note that the graphs have different scales. In any case, the aim is not to compare the magnitude of the gains – one graph is measuring the impact of a single proposal, the
other of several years of reforms – but rather the gradient of the gains across the income distribution.)

As can be seen, while the impact of the Lib Dem tax cut would be broadly regressive, giving more to the richer half of society, the impact of Labour’s reforms has been highly progressive, giving more to the poorer half. And while the Lib Dems deserve praise for their proposals to close tax avoidance loopholes and to ask the super-rich to pay a fairer share, this does not prevent the impact of their combined tax package being regressive overall.

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As a final observation, perhaps the most disappointing aspect of the Liberal Democrats’ new position on tax is the implied political agenda underpinning it.

By presenting the payment of tax as harmful without consideration of what taxation makes possible, this agenda risks pandering to a particular kind of libertarian, anti-tax mentality, which can only see taxation as restricting freedom.

Sadly, Nick Clegg seems to have bought into this anti-tax language on occasions, selling the Lib Dems’ proposal as guaranteeing “tax freedom” to people – a phrase straight out of the US Republicans’ phrasebook.21 Perhaps he does not intend this language to carry the libertarian baggage it might imply. But once you start off down this route, it will slowly and surely take you to its nonsensical endpoint: the hypocrisy of those (like the Taxpayers’ Alliance) who want to celebrate ‘Tax Freedom Day’, but seem happy to carry on using roads and hospitals the whole year round.

Most people are more intelligent than that, recognising that taxes are the price we pay for living in a civilised society. Of course, our real fundamental freedoms – from the right to private property, access to clean air and water, and freedom from assault, to the right to healthcare and education – are only made possible through significant public expenditures, underpinned, of course, by taxation. As a brief glance at regions of Somalia or Yemen illustrates, the result of a government unable to extract taxation from its citizens and spend the revenue on public goods is not more freedom, but less – chaos, lawlessness and fear.

Earlier, we noted that Sweden and Denmark have very low poverty and inequality by international standards. The way they have achieved this has not been through an agenda of ‘tax freedom’ and ‘taking people out of tax’, but through a generous welfare state of which everyone is part, underpinned by a ‘pro-public’ culture where tax isn’t regarded as necessarily being a bad thing. In particular, these countries have public services and systems of financial support for households that together redistribute income to the poorest, whilst giving everyone a stake in them.

That is what any party affecting to claim the mantle of ‘tax fairness’ should aspire to.

21 For example, Nick Clegg, speech, 11 Jan 2010; Nick Clegg, speech to Barnardo’s, 1 Feb 2010.
Appendix

This appendix briefly illustrates what the impact would be of an increase in the personal allowance to £10,000 without a simultaneous downwards adjustment in the higher rate threshold.

This shows what the impact of the policy would be if the Lib Dems were not to make this adjustment, but simply increased the personal allowance to £10,000. It also allows us to examine the difference that making this adjustment does or doesn’t make. (After all, while this is not an issue for the Liberal Democrats, it is an issue for other proposals to increase tax allowances that routinely get made.)

For simple increases in tax allowances, i.e. without a corresponding downwards adjustment of the higher rate threshold, the amount gained depends on an individual’s marginal rate of tax. This is because, as discussed in earlier in the report, if the width of the basic rate ‘taxable band’ remains the same, then increasing the level of income at which the basic rate starts also shifts upwards the point at which higher rate begins. The result is that, when thresholds are increased in a simple way, income becomes exempted from taxation at your marginal rate of tax. In other words, higher-rate payers gain twice as much as basic-rate payers. The process is illustrated in the box below.

<table>
<thead>
<tr>
<th>Box 2: How the value of increasing the personal allowance depends on your marginal tax rate</th>
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<tr>
<td><strong>The basic rate-payer:</strong> Angela earns £20,000. Under the current system, she pays no tax on the first £6,475. She then pays 20% on the remainder of her income up to £20,000 – that is, on some £13,525 worth of income. If the personal allowance is now increased to £10,000, she now pays no tax on the first £10,000. She then pays 20% on the remainder of their income up to £20,000 – that is, on some £10,000 worth of income. So the £3,525 increase in the personal allowance has reduced the amount of income on which she pays the basic rate of tax by £3,525, saving her £705 a year (20% of £3,525) or £13.56 a week.</td>
</tr>
<tr>
<td><strong>The higher rate-payer under a simple increase in the personal allowance:</strong> Beth earns £50,000. Under the current system, she pays no tax on the first £6,475. She then pays 20% on the next £37,400, that is, on her income from £6,475 up to £43,875. (This is because the basic rate ‘taxable band’ is the first £37,400 of taxable income.) She then pays 40% on the remainder of her income, up to £50,000 – that is, on some £6,125 worth of income. If the personal allowance is now increased to £10,000, she now pays no tax on the first £10,000. She then pays 20% on the next £37,400, that is, on her income from £10,000 up to £47,400. She then pays 40% on the remainder of her income up to £50,000 - now just £2,600 worth of income. So the £3,525 increase in the personal allowance has reduced the amount of income on which she pays the higher rate of tax by £3,525, saving her £1,410 a year (40% of £3,525) or £27.12 a week. <em>So without a downwards adjustment in the higher rate threshold, the higher-rate payer gains twice what the basic-rate payer does.</em></td>
</tr>
</tbody>
</table>
| **The higher rate-payer under an increase in the personal allowance combined with a downwards adjustment of the ‘higher rate threshold’:** Beth earns £50,000. Under the current system, she pays no tax on the first £6,475. She then pays 20% on the next £37,400, that is, on her income from £6,475 up to £43,875. She then pays 40% on the remainder of her income, up to £50,000 – that is, on some £6,125 worth of income. If the personal allowance is now increased to £10,000 and the basic rate taxable band is now reduced to just the first £33,875 of taxable income, she now pays no tax on the first £10,000; she then pays 20% on the next £33,875, that is, on her income from £10,000 up to £43,875. She then pays 40% on the remainder of her income up to £50,000 – still £6,125 worth of income. So the £3,525 increase in the personal allowance combined with a £3,525 reduction in the ‘higher rate threshold’ has reduced the amount
The graphs below compare the impact of a simple increase in the personal allowance to £10,000, with that of the policy examined earlier in the report, namely, increasing the personal allowance to £10,000, with a corresponding £3,525 reduction in the higher rate threshold. The first shows the gains to households (£ / week) by income decile; the second shows the percentage change in net household income by income decile.

GRAPH 8: Average gains per decile (£ / week) to households from both an increase the personal allowance to £10,000 combined with a corresponding downwards adjustment of the ‘higher rate threshold’ (first data series), and from a simple increase in the personal allowance to £10,000 (second data series). Modelling by Landman Economics
As can be seen, for both analyses, the profile of the impact across the population is broadly the same as before (although slightly more generous, as the policy now costs £20.1 billion), though the richest income decile now does somewhat better – in both cash and relative terms.

The regressive profile of the package is broadly the same: the gains become progressively greater as you move up the income spectrum from poorest to richest. Those in the 6th decile still get on average three times as much (£15.56 a week) as the poorest decile (£5.51 a week); those in the 9th decile still get on average four times as much (£22.04 a week). In terms of the percentage change in household income, once again, those on lower incomes get smaller proportionate gains: households in the 5th and 6th deciles have their income increased on average by 3% or more, whereas households in the 1st and 2nd deciles have their incomes increased by only 1.8%.

So making this downwards adjustment to the higher rate threshold reduces the cost of the policy from £20.1 billion to £17.8 billion, and makes the policy less generous to the richest income decile than it would have been.

Making this adjustment is therefore welcome, of course. But the main conclusion here is that it actually does quite little to moderate the regressivity of a simple increase in the personal allowance.

This is because the distributional problems with trying to increase the personal allowance emerge from broader aspects of the structure of our tax system: cutting progressive taxes in this way has a regressive impact. That is why alternative mechanisms, like tax credits and benefits, are fairer.
About the authors

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