# {Section 4}
# What can be done?

## Chapter 11
# Better support through the tax and benefit system

## Chapter summary

- Easing the squeeze within fiscal constraints means both rebalancing spending towards investments that more directly support living standards and fixing egregious design flaws.
- To fund our proposals on affordable childcare and second earners the government should reduce tax relief on pension contributions for the very wealthy, lowering the lifetime allowance for Pension Tax Relief to £1 million, raising £1.5 billion.
- Households and government can afford design flaws even less when finances are so squeezed. Council Tax is perhaps the most egregious tax for low to middle income households. Several extra top bands should be added in order to cut rates lower down.
- The tax and benefit system needs to rebalance from compensating for low wage work to reducing its incidence and effects. Universal Credit should be built on to better support those struggling to escape low pay.

If the UK tax and benefit system is to better support living standards in a constrained spending environment, established approaches will need to be rethought. Although as a Commission we have not sought a shared position on the overall level of public spending, we are clear that, even within the government's medium-term fiscal plans for deficit reduction, it is possible for the tax and benefit system to do more. This chapter approaches this question in three main ways, by asking:

- *Where spending could be rebalanced, switching money towards more productive investments that have a tighter link to living standards;*
- *If there are longstanding inefficiencies in the system, especially ones that impact heavily on low to middle income households, that now need to be tackled;*
- *If the tax and benefit system could play a more effective role in some areas such as assisting progression out of low-paid work.*

Whatever one's position on the pace of deficit reduction, there is little doubt that the UK – indeed much of the developed world – is now entering a prolonged period of fiscal pressure. According to the OBR, demographic trends are set to increase UK spending on health and social care so significantly that in the absence of much stronger growth or increased migration, further consolidation could be required well beyond the current spending review period just to avoid sustained deterioration in the country's public finances.[1] Unless this position changes, it suggests that an unprecedented squeeze on living standards will need to be addressed without significant new spending or by funding new spending with commensurate increases in revenue.

# 11a Rebalancing spending towards productive investments

It is more important than ever that the government is focused on raising employment incomes

In this report we have identified several areas for increased investment, some of which can be achieved in a cost neutral way. For example, targeting cash benefits on parents of younger children could be done by gradually reprioritising spending away from parents with older children. However, some proposals, like increased investment in childcare, will come at a net cost to government. Our argument is that these areas, of such direct importance to living standards, are now bigger priorities than some other areas of existing spending or that they merit specific revenue raising.

There is no easy way to switch spending from one area to another without creating winners and losers, just as any tax rise must be paid for by someone, however indirectly. Our test in identifying potential spending cuts or revenue raising opportunities has been to balance three objectives:

- *to improve the efficiency and/or coherence of the tax system as a whole;*
- *to support low to middle income households by retaining or increasing progressivity;*
- *to pass a very basic test of political plausibility.*

**While no tax reform is perfect, we have sought to balance efficiency with political feasibility**

One way of identifying feasible candidates for revenue raising is to think about how the UK's society and economy have changed since the existing systems were designed. One such change, as we saw in Chapter 3, is ongoing growth in inter-generational disparities in income and wealth. An older generation that is on average unprecedentedly wealthy, but also extremely diverse, containing major disparities of poverty and wealth, is now nearing retirement. It is also the case that, to date, the weight of fiscal consolidation has been borne by working-age people, accentuating rather than mitigating generational inequalitites.

[1] OBR, (2012), Fiscal Sustainability Report 2012, Office for Budget Responsibility, London.

# 11b Raising revenue

Reducing generous tax reliefs on pension contributions, which overwhelmingly benefit those with very high incomes

This points to a potentially progressive way of raising revenue: reforming the very generous tax reliefs on pension contributions, which overwhelmingly benefit those with the very highest incomes. Two aspects of the current regime stand out as being both expensive and regressive.

First, National Insurance Contributions (NICs) are currently charged on employee contributions to private pensions, but employer contributions are exempt from NICs at the point of contribution and the point of withdrawal. There is no clear justification for such generous treatment of employer contributions, nor for treating employer and employee contributions differently. HMRC estimates that this tax relief was worth around £8.3 billion in total in 2009-10.

Second, income tax on employee pension contributions is currently deferred until pension income is withdrawn in retirement. Very few pensioners currently pay income tax at the higher or additional rate, meaning that large numbers receive tax relief at the 40 per cent rate and then pay only the basic rate of 20 per cent on their retirement income. In addition, individuals can take 25 per cent of whatever pension funds they have built up as a tax free lump sum on retirement (up to a maximum of £375,000), so that direct tax is not paid on this income at any point. While encouraging pension savings is a vital policy objective – particularly for those on low and middle incomes – these generous reliefs overwhelmingly benefit the wealthiest households. The government recently estimated that restricting tax relief on pension contributions to the basic rate would raise an additional £7 billion a year in income tax revenues.[2]

> Generous reliefs on pension contributions overwhelmingly benefit the wealthiest households

Both of these revenue sources could be used to support the low to middle income group better. But while there is a case for applying NICs on employer pension contributions, in the current economic climate we think it would be unwise to increase burdens on employers. Instead, we favour reducing the generosity of personal and occupational Pension Tax Relief to help fund our proposals aimed at raising employment income: highly affordable, accessible childcare and a disregard so that low-paid second earners keep more of their pay.

**Cap the lifetime tax free allowance at £1 million, raising £1–1.5 billion per year**

There are a number of ways to reduce the overall generosity of Pension Tax Relief, including: restricting all relief on contributions to the basic rate (raising an additional £7 billion per year); reducing the maximum size of the tax free lump sum; reducing the annual limit on tax free contributions (currently £50,000); and reducing the lifetime cap on pension contributions, currently £1.5 million. All these proposals have their pros and cons and could in theory raise far more than is required to pay for all the proposals in this report.

Overall, the collective position of the Commission is to favour a reduction in the value of the lifetime allowance for pension contributions to £1 million. This would reduce relief for the highest earners. It is a fairer way to limit reliefs than the annual limit, targeting those with the highest lifetime incomes.

Data on higher rate Pension Tax Relief is notoriously poor but reasonable estimates based on new data provided by HMRC put the money raised by this change at £1–1.5 billion per year, and likely towards the upper end of this range (see Annex C for detailed costings). The main obstacle to this change would be the administrative challenge of dealing with defined benefit schemes, which would take up a small portion of the overall amount raised.

[2] Johnson, P. et al., (2012), Pensioners and the Tax and Benefit System, Institute for Fiscal Studies, London.

# 11c Addressing serious design flaws

Addressing aspects of the tax system that are particularly inefficient or regressive

We have shown how spending could be rebalanced to allow greater investment in pro-employment public services that disproportionately benefit low income families with children. In addition, policymakers urgently need to address aspects of the tax system that are particularly inefficient or regressive. Government and households can ill afford these at the best of times and much less so when we face an unprecedented squeeze on the public finances and household incomes. We do not pretend to provide a comprehensive audit of the tax and benefit system but we are concerned with aspects of the system that are flawed from a design perspective and that are particularly egregious for low to middle income households.

There are many such flaws, not least the extremely inefficient way in which the government tries to support those on low incomes through a complex system of Value Added Tax (VAT) exemptions. The cost of our failure to take on reforms like these is paid for directly by low to middle income households in higher taxes and less support than would otherwise be possible.

**Council Tax stands out as a regressive tax in need of reform**

Perhaps the worst culprit is Council Tax. It is the only part of the UK tax system designed intentionally to be regressive, with rates as a proportion of property value falling as property values rise. This is the equivalent of levying a lower rate of VAT on a Ferrari than a Ford Focus and has no economic justification.[3] Rates are not only regressive but also arbitrary, being based on house values last assessed in the early 1990s.

Ideally Council Tax would be reformed through a full revaluation of house prices, combined with a simpler system based on a single, proportional rate linked to property values – essentially a (very low) flat tax on housing. The political obstacles to such reform are significant and we therefore do not hold this up as a potential source of new revenue. However, the government could adopt a more modest and achievable reform by adding several new bands to the top of the Council Tax scale to enable a cut in Council Tax for lower value properties.

Council Tax is not our main concern as a Commission, not least because we are realistic that only marginal reforms would be politically feasible. But we address it here because of its significance for low to middle income households. Council Tax bills take up 5 per cent of disposable income for an average low to middle income household and despite recent freezes their cost has soared in the past decade; the cost of Council Tax grew by just 10 per cent in the 1990s but by 67 per cent in the 2000s.

[3] Even based on early 1990s property values, occupants of Band H houses (the highest band) pay at most 1 per cent of their property value a year while occupants of Band A houses pay at least 2.6 per cent. On the basis of today's house prices this disparity would be far larger.

# 11d Recognising the importance of children

There is broad support for reducing the tax burden on low and middle income households

Throughout this report we have argued that employment income will need to provide a bigger share of income growth in the next ten years than it provided in the last 10. But we have also argued that the tax and benefit system will continue to play an essential role in supporting low income households with children.

As things stand, the current government is committed to raising the threshold at which individuals start paying income tax (the Personal Tax Allowance) to £10,000. This is a major commitment even if the significance can be slightly overstated since around a third of the increase would have happened anyway.[4] Raising the Personal Tax Allowance above the rate of inflation (and indeed earnings) now seems likely to remain at the heart of debates about tax reform. Further increases to £12,500, around annual earnings at the National Minimum Wage, have been mooted.

Over the medium term, it is not clear to what extent, or how, the government plans to support low to middle income households with children

The prominence of the Personal Tax Allowance policy suggests a political desire to use the tax system to support struggling households. Is this the best way to support low to middle income households? This question leads inevitably to fundamental issues in the design of our tax and benefit system.

### The Personal Tax Allowance is poorly targeted on low to middle incomes households

While an increased allowance benefits the great majority of those in work (though not the minority earning less than the Personal Tax Allowance or those with earnings over £114,950) it is not a well targeted way of supporting low to middle incomes households, particularly those with children. First, the benefits of a higher Personal Tax Allowance are spread very widely and far up the income scale. Second, because income tax is assessed for individuals rather than households, the policy does nothing to target families with children who may be in greater need. Around 70 per cent of the most recently announced increase in the Personal Tax Allowance goes to households in the top half of the income distribution.[5]

### The state is rebalancing from tax credits to using the tax system to support low income households

As we saw in Chapter 6, there has been a shift away from recognising children through the tax system over the last 30 or years (through family allowances and Child Tax Allowance) towards doing so through benefits and tax credits, with the introduction of Child Benefit and more recently the rise of Child Tax Credit. The balance between raising the Personal Tax Allowance and planned spending on Universal Credit now represents a shift away from the benefit and tax credit system as the favoured mechanism for supporting low income families. This has upsides and downsides. Tax credits (and Universal Credit) better target low income households and in particular families with children. An inevitable downside of this targeting is that, because they are withdrawn as earnings rise, they also make it harder for people to increase their income through better pay or more hours of work. In comparison raising the Personal Tax Allowance is far less well targeted but does not increase marginal tax rates.

### The government needs to find a sustainable way to support households with children

We have seen that, although they have fared well in the past 20 years, working-age households with children have borne the brunt of post-recession fiscal consolidation. Over the medium term, it is not clear to what extent, or how, the government plans to better support low to middle income households with children. As we have discussed, there are a number of ways of doing this, including through tax credits and Child Benefit. While we have not taken a view on this difficult judgement, as is it beyond remit, this is an important area for future debate and there is a clear need for a coherent approach.

[4] Because of annual increases of the Personal Tax Allowance in line with inflation [5] Based on equivalised incomes. This figure relates to the increase in the allowance to £9,205 in April 2013. This increase was more progressive than the 2012 increase in the PTA, which was not targeted at basic rate taxpayers, and which led to an even higher proportion of gains going to households in the top half of the income distribution. [6] Solow, R., (2008), "Low Wage Work in Europe and America", Lecture to the 3rd meeting of Nobel Laureates in the economic sciences, The Lindau Mediatheque: http://www.mediatheque.lindau-nobel.org/#/Video?id=433 [Accessed 3 October 2012] [7] DWP, (2010), "Universal Credit: Welfare that works", Department for Work and Pensions, London.

# 11e Boosting progression at the bottom

Finally, a core argument of this report has been that Britain needs a new national project to reduce the incidence of low pay in our jobs market. We have pointed to areas of potential from skills and the National Minimum Wage to the importance of new and stronger labour market institutions. But the role of the tax and benefit system also needs to change. Put crudely, the task is to move from a world in which the tax and benefit system compensates for the problem of low wage work to one in which it proactively contributes to its reduction and mitigates its effects. This is a new and experimental area that will require policy development.

**Low pay comes at a large direct cost to government**

We have already made the case for a more experimental approach to reducing low pay, by working with firms and individuals to redesign jobs and improve skills levels, helping businesses to move away from low paying strategies. One other important question is how the tax and benefit system could do more to support progression.

**Helping individuals to progress**

The extent to which the tax and benefit system helps people move out of low pay or leaves them stuck is critical. One of the interesting differences between low pay in the UK and Denmark, for example, is the prominence of young people carrying out low wage work. In Denmark, where collective pay agreements sometimes have an age cut off, low wage work is more often carried out by students part time; 63 per cent of the low paid in Denmark are young compared with 34 per cent in the UK. In the words of Nobel Laureate Robert Solow, low wage work in Denmark is a shared burden, rotating between young people "in the way that boring committee assignments rotate in academic departments".[6] This difference matters for mobility.

We must move from a world in which the tax and benefit system compensates for low pay to one in which it reduces its incidence and effects

**The introduction of Universal Credit provides a new opportunity to support progression for those on low pay**

What can be done in the UK, without strong labour market institutions, to encourage progression out of low-paid jobs? In part this may require institutional innovation. The introduction of Universal Credit also presents an opportunity. One lesser known aspect of the Universal Credit system is that it will place work-related conditionality on all recipients until they earn the equivalent of a full-time salary at the National Minimum Wage.[7] The details of the new in-work conditionality regime remain unclear and raise significant practical challenges, particularly given the current scale of under-employment.[8] One the one hand, the new system needs some form of conditionality regime in order to control costs. On the other hand, it is not yet clear how Jobcentre Plus will cope with a dramatically increased caseload given that over a million people meet the criteria for in-work conditionality and no additional funding has yet been earmarked.

Unquestionably, though, there is a need for more structured support to help those who are in work but stuck on low pay. With Universal Credit shortly to change the relationship between low earners and the state, with large swaths of people in low-paid work potentially required to contact Jobcentre Plus regularly, this is an opportunity to think more creatively about the support that could be provided. Universal Credit could be used, for example, to provide people who are struggling to progress into better paid work with access to skills support. It could also be a way of helping parents to access the childcare they need to work additional hours or to offer advice on writing CVs to those looking to progress. Whatever the actual systems of support look like, in-work conditionality is the kind of opportunity that needs to be seized if we are to address more actively the problem of progression out of low wage work.

This section described what we have called key ingredients for shared growth in the 21st century. Much of the discussion has focused on specific steps that could be taken, many of which raise complex questions of design and implementation. But our real focus is on the bigger argument – the three key ingredients of shared growth:

· *Broad-based growth in wages*, backed by a skills system that gives people in the bottom half of the UK workforce – including those who don't go to university – access to good jobs; and labour market institutions that encourage employers to share their proceeds broadly;

· *Fuller and broader employment*, including higher employment among key groups like parents and older workers, backed by pro-employment public services and a tax and benefit system that does more to support employment;

· *Smart support from state* that is better focused on raising material living standards, more attuned to incentive effects, and in which low to middle income households don't have to pay the price for regressive design flaws.

[8] Pennycock, M. and Whittaker, M. (2012) "Conditions uncertain: Assessing the implications of Universal Credit in work conditionality", Resolution Foundation, London.