{Section 2}
The long view: Tracking the long term drivers of living standards

Chapter 6
The receding tide of state support

Chapter summary

- State support was the only source of rising incomes among low to middle income households in the run up to the 2008 crisis, principally through tax credits.
- Now fiscal pressures mean that past growth in tax credit spending – 4.9 per cent a year in real terms from 2003 to 2008 – cannot be repeated.
- Tax credits have an inevitable downside, with millions now facing marginal tax rates above 70 per cent, rising further under Universal Credit.
- These factors necessitate a shift in the balance of growth away from state support towards employment income.
- This all has particularly tough implications for households with children, who have already been hit twice as hard by cuts to public spending as households without children and more than three times as hard as pensioner households.
- A minimum standard of living for those with children cannot be guaranteed through mechanisms like tax cuts or the National Minimum Wage or Living Wage, which target individuals rather than families.

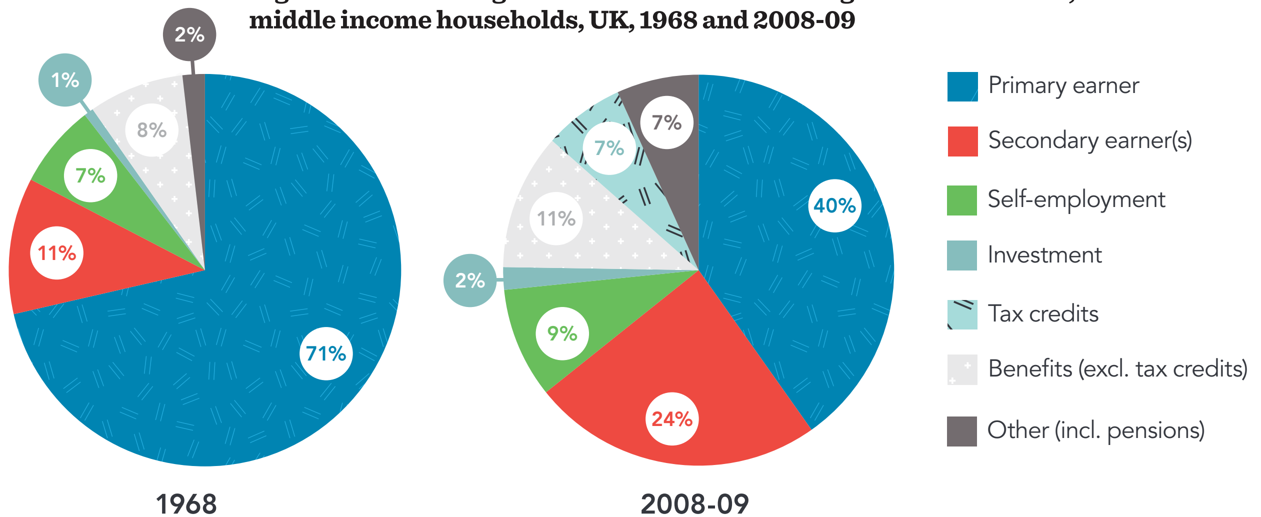
As we saw in Section 1, the UK tax and benefit system has come to play an increasingly important role in determining household incomes. Between 2003 and 2008, total spending on tax credits grew at 4.9 per cent a year in real terms and tax credits were the only major source of household income growth for low to middle income households. This accelerated a longer-term trend whereby the state came to play a more important role in supporting living standards. Over the period 1968 to 2008-09, benefits and tax credits accounted for more than one-third (17 per cent each) of the *growth* in net household income for low to middle income households, compared with 27 per cent from female employment income (Figure 6.1). As a result, benefits and tax credits accounted for about 18 per cent of total household income in 2008-09, up from just 8 per cent in 1968.

6a The need to shift away from growing state support

In the current fiscal climate it is highly unlikely that any government would seek to emulate the growth in tax credits that occurred in the early 2000s. Continuing the growth rate of the 2002-03 to 2007-08 period would have seen spending rise to £37 billion a year by 2015-16. Instead, under current spending plans, total tax credit expenditure is set to decline. This reflects several decisions made in the 2010 spending review, including a tighter means-test to withdraw support from middle income households and, most importantly, the decision to switch the indexation of benefits and tax credits from the RPI to the CPI measure of inflation. As attention turns to the next spending review, the government has already indicated that it will look for substantial additional savings from the welfare budget, potentially including tax credits.[1] Indeed, as we will see in Section 3, under current plans state transfers are now set to decline steeply as a proportion of income in low to middle income households.

The existence of a system like tax credits is likely to be an essential ingredient for shared growth (see In depth 6.1). But such systems also have inevitable downsides. We consider both issues in this chapter, while also discussing the specific roles the tax and benefit system plays that wages simply cannot, particularly supporting households with children.

Figure 6.1: Percentage of after-tax income coming from each source, low to middle income households, UK, 1968 and 2008-09



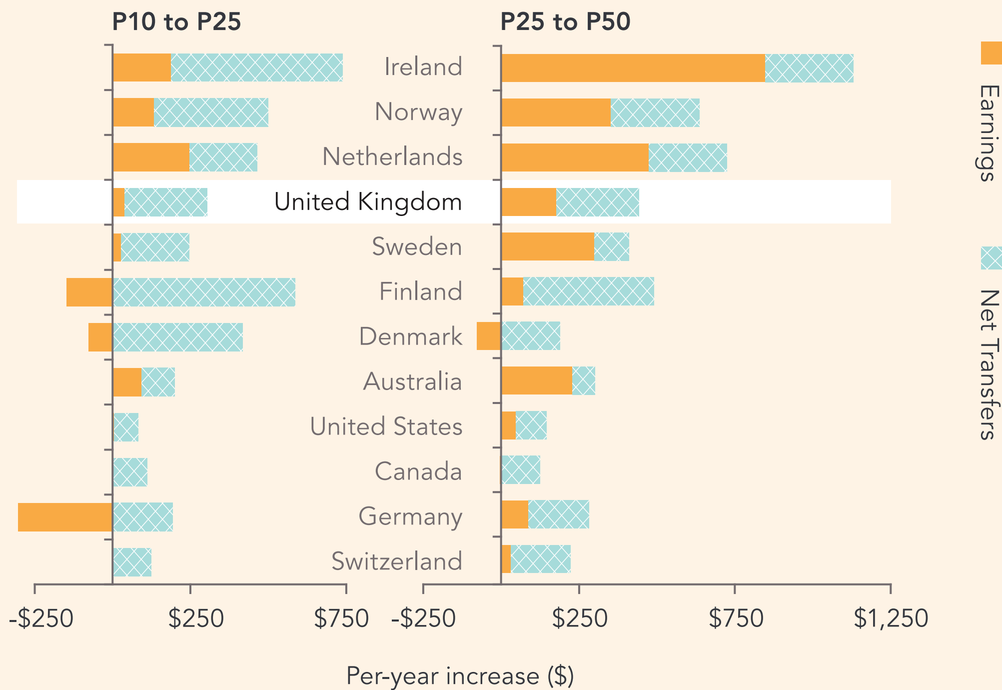
Note: Share of total net household income (household incomes are equivalised for the purpose of defining the low to middle income group).
Source: Brewer and Wren-Lewis, Why Did Britain's Households Get Richer?

[1] Budget 2012 statement by the Chancellor of the Exchequer, the Rt Hon George Osborne MP, www.hm-treasury.gov.uk/budget2012_statement.htm (accessed 23 August 2012).

In depth 6.1: How important has redistribution been in sharing the proceeds of growth?

For households on lower incomes, an established system of cash transfers is extremely important. Research for the Commission by Professor Lane Kenworthy[2] looks at the sources of income growth for "low income" and "modest income" households (defined as deciles 10–25 and 25–50, respectively) from 1979 to 2005 (Figure 6.2). Where net transfers increased (Norway, the UK, Sweden, Finland, and Denmark), the incomes of low and modest income households tended to grow in concert with economic growth. Where net transfers were stagnant, incomes were decoupled from growth, a trend observed in the US, Canada and Switzerland.

Figure 6.2 Average yearly increase in earnings and in net government transfers in P10 to P50 households, various countries, 1979–2005



Note: The countries are ordered according to average yearly increase in income in P10 to P50 households. The actual years vary somewhat depending on the country. The data is averages for size-adjusted household earnings and net government transfers (cash and near-cash transfers received minus taxes paid). The amounts shown are for a household with four persons; for a one-person household, divide by two. Incomes are adjusted for inflation using the CPI and converted to US dollars using PPPs. Source: Kenworthy, Why Do Low to Middle Income Households Get Better Off?; calculations using income data from the Luxembourg Income Study Database and inflation and PPP data from the OECD

These findings suggest that, as a general rule, growth does not trickle down to the lowest income households through wages or employment. The UK is not alone in having relied on a system like tax credits. Advanced economies as different as the US and Sweden have now realised that it is necessary to have some form of cash transfer for low (or low to middle) income working households. While we have been clear that past growth in state support cannot be repeated, these findings show how important it will be to protect the role of tax credits in supporting working families.

[2] Kenworthy, Why Do Low to Middle Income Households Get Better Off?

6b The inevitable downsides of direct state support

Broad-based wage growth has declined across the OECD

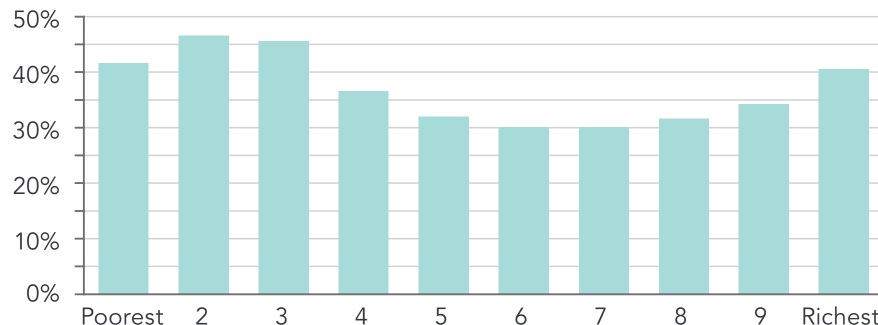
While significant growth in spending may have been necessary to establish tax credits as an important new system of support, no one envisaged permanent growth at such a high rate. Indeed, there are many reasons that the UK should now actively shift from state support to employment income as the principal source of rising living standards.

We saw in Chapter 2 that it is unlikely that tax credits significantly pushed down wages. Even so, other criticisms have more weight. One is that people are not neutral between different sources of income and significantly prefer earned income to income provided by the state.[3] The design of tax credits sought in part to surmount this problem by presenting tax credits, in a sense, as a negative tax. Yet the continuing and strong preference for earned income as well as the relative ease with which the tax credit budget has been reduced is revealing.

The effect of tax credits on work incentives has also been stark. While the Working Tax Credit has substantially improved the incentive to move into work for some groups, tax credits in general have weakened the incentive for people who already work to earn more. Any individual paying the basic rate of income tax (20 per cent), employee NICs (12 per cent) and receiving tax credits (which are withdrawn at a rate of 41 per cent) now pays an effective tax rate of 73 per cent.[4] This means they keep 27 pence of every additional pound they earn. This is an inevitable drawback of any means-tested system of redistribution and needs to be traded off against the advantages of directing support towards the households that need it most.

Stepping back, the overall effect of these high effective tax rates on households is significant. Figure 6.3 shows that even by 2020 marginal deduction rates are expected to be high for low income households. The highest rates – higher even than for the richest households – are paid by households in deciles 2 and 3 who are most likely to both pay employment taxes and receive tax credits or benefits which are withdrawn when their incomes rise. As a result, it will be harder for employment income to raise incomes in these households. Those in the bottom half of the wage distribution will find this rebalancing period an uphill struggle.

Figure 6.3: Average marginal effective tax rate (%) on earned income among workers in the UK, by household income decile group, 2020-21



Notes: Assumes full take-up of benefits. Definitions of earnings and net household income as in Figures 5.1 to 5.6.
Sources: IER & IFS calculations for the Resolution Foundation, Family Resources Survey 2008-09, IFS TAXBEN model.

[3] See for example Tu, T. and Ginnis, S., (2012), Work and the Welfare System: A survey of benefits and tax credits recipients, Ipsos MORI for the Department for Work and Pensions; Dean, H., (2007), "Poor parents? The realities of work-life balance in a low-income neighbourhood", Benefits: A journal of poverty and social justice, 15 (3), pp. 271–282. [4] Other households face higher withdrawal rates under the current system, particularly those receiving Housing Benefit. Universal Credit is likely to reduce many of these very high withdrawal rates, depending on how local authorities choose to administer Council Tax Benefit (which will be localised under the new system).

6c The essential role played by tax credits

Tax credits target support according to family need – a function the labour market cannot simply replace

While tax credits had downsides, it is important to remember that the tax and benefit system plays a role that wages cannot. Whereas wages are paid to individuals, only the tax and benefit system accounts for the wider needs of families and in particular the presence of children. Earlier in the 20th century, the tax system could in theory have been used to target support at low income households, but now it functionally cannot. This is because, while the state has always recognised the presence of children to some degree, over time there has been a shift from the tax to the benefits system as the principal way of doing so.

This started with the move to individual taxation. The Child Tax Allowance (which meant that families with children paid less tax) was phased out in 1977 (being replaced by Child Benefit), while the Married Man's Allowance lost value over time. In 1990 income tax moved to individual assessment rather than family assessment. As a result, taxes now redistribute between individuals rather than families, with a parent of four children, for example, paying the same rate of tax, and receiving the same tax allowances, as a single person.

Only the tax and benefit system accounts for the wider needs of families and in particular the presence of children

To compensate for the move to an individualised tax system, the benefit system has increasingly come to take family composition into account, most recently through the introduction of Child Tax Credit in 2003.[5] As this transition took place, some key elements of the tax system, like the Personal Tax Allowance, fell in real terms.

These long-term changes in taxes and benefits have big implications for policy and for living standards. For example, the last government's ambition to reduce child poverty had to be carried out by increasing benefits or tax credits rather than by reducing taxes for the low paid. Today, the brunt of fiscal consolidation, having come from working-age benefits, has been borne by households with children, as we saw in Chapter 5.[6] A further implication is that a strategy focused on the Personal Tax Allowance rather than household-based support like tax credits (assuming it is not coupled with a reversal of the above tax reforms) will disadvantage households with children.

Wages can never guarantee families a minimum standard of living

A similar limitation applies to policies like the National Minimum Wage, which boost wages but clearly don't acknowledge the number of children in a family.[7] In fact, this is explicitly recognised in the design of the Living Wage, the value of which is premised on a family fully taking up tax credits and other means-tested benefits; the Living Wage is the wage that delivers a minimum standard of living once you add on tax credits. Without these entitlements, the appropriate rates would be far higher. For example, the Greater London Authority (GLA) estimates that an hourly London Living Wage rate of £10.40 would be required if means-tested benefits were excluded from the calculations, rather than the current rate of £8.30.[8] The implication is that, even if the UK achieves growth in the minimum wage to this level over the very long term, a system like tax credits will still be essential if low and modest incomes households are to share in the proceeds of growth.

6d Conclusion

The main source of rising incomes for much of the last decade now looks likely to go into reverse. Income from employment – whether rising hourly wages or rising employment levels – will have to take more of the strain in boosting household incomes. This is no mean feat. As mentioned above (In depth 6.1), only in exceptional circumstances has any advanced economy achieved strong growth in living standards for the lowest income households directly through the market, rather than through cash transfers.

High marginal tax rates will make this an uphill struggle. For those with children in particular, it will be crucial that tax credits don't fall substantially in value.

[5] Gregg, P., Hurrell, A. and Whittaker, M., (2012), Creditworthy: Assessing the impact of tax credits in the last decade and considering what this means for Universal Credit, Resolution Foundation. [6] Analysis at the time of the 2012 Budget showed that by 2014 households with children will have had a 4.7 per cent decline in annual net income (£1,781 in cash terms) as a result of the current government's tax-benefit reforms, compared with 2.3 per cent (£751) for working-age households without children and 1.4 per cent (£316) for pensioner households. See Joyce, R., (2012), Tax and Benefit Changes, Excluding Those Affecting Mainly the Very Rich, Institute for Fiscal Studies, www.ifs.org.uk/budgets/budget2012/budget2012robjoyce.pdf (accessed 1 October 2012). [7] This argument is made well in the relation to the Living Wage in Bennett, F. and Lister, R., (2010), The Living Wage: The right answer to low pay?, Fabian society briefing paper, London. [8] Defined as tax credits, housing benefits and council tax benefits. See GLA Economics, (2011), A Fairer London: The 2011 Living Wage in London, GLA Economics, Living Wage Unit, p. 17