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Social Policy in a Cold Climate

Summary Working Paper 11

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The Coalition's Record on Cash Transfers, Poverty and Inequality 2010-2015

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Presenting his 2010 spending review, George Osborne, the Chancellor, insisted that "those with the broadest shoulders should bear the greatest burden". How did the Coalition's benefit and direct tax policies affect the distribution of incomes, inequality and poverty?

- The Coalition's immediate priorities affecting 'cash transfers' included increasing the income tax allowance towards £10,000 and a more generous system for increasing state pensions each year. Plans to amalgamate working-age benefits to create Universal Credit and introduce a 'single-tier' pension also emerged as flagship reforms.
- Benefits continued to increase with prices for the first two years, shielding many on low incomes from the effects of recession. As real incomes fell in the middle of the income distribution, inequality and relative poverty fell between 2009/10 and 2010/11 and were flat in the following two years to 2012/13 (the latest with available data). But poverty rose against a fixed real line.
- After 2012 many working-age benefits were cut in real terms, but spending on pensions continued to rise. In 2009/10, Labour's last complete year, total spending on cash transfers was£182 billion, or 12.7 per cent of GDP. By 2014/15 projected spending had reached £188 billion (in 2009/10 prices), but had fallen as a proportion of GDP to 12.1 per cent.
- Modelling suggests changes to *direct* taxes, tax credits and benefits from May 2010 to 2014/15 were together fiscally neutral, rather than contributing to deficit reduction. They were also mainly regressive: tax credit and benefit cuts took more away from those in the bottom half of the income distribution than they gained through higher income tax allowances.
- Longer-term plans to continue linking working-age benefits to price inflation (or less) while pensions increase faster will further tilt policy in favour of pensioners. They will also extend the generally regressive effect of policy, except that Universal Credit may deliver more money to some poorer households, *if* it is claimed by some who do not claim all of the benefits it replaces.
- Child and working age poverty are projected to be higher in 2014/15 than in 2012/13, with further increases forecast to 2020/21. Deeper cuts to non-pensioner benefits and tax credits after the 2015 election would increase poverty, but the official target of eradicating child poverty by 2020, endorsed by the Coalition and Labour, already appears beyond reach.

Introduction

The Conservatives talked of 'broken Britain' during the 2010 election campaign, but they and their Liberal Democrat coalition partners came to power at a time when progress had been made reducing poverty and inequalities in many respects. Labour's policies on tax credits and benefits (collectively known as 'cash transfers') had prioritised families with dependent children and older people. As a consequence, child poverty fell by a third between 1996/97 and 2010/11 (before allowing for housing costs) and pensioner poverty by 30 per cent. But poverty for people of working-age had increased. Although Labour avoided the language of 'redistribution', its tax and benefit policies had an overall effect of redistributing income from the top half of the distribution towards the lower half.

Total spending on cash transfers, measured as a proportion of national income, had been the same in 2007/08 as it was in 1996/97. But after recession took hold, a combination of rising claims for unemployment benefits and falling real-terms national income meant cash transfers were 2 per cent more of GDP in 2009/10 and 2010/11 than they had been in 1996/97.

What were the Coalition's aims and goals?

The Coalition's *Programme for Government* strikingly embraced two key – and expensive – tax and benefit proposals from its junior, Liberal Democrat partners. These were to progress towards a £10,000 income tax allowance and introduce a 'triple lock' on the basic state pension. The latter meant pensions would increase each year by the rate of price inflation, earnings, or 2.5 per cent, whichever was greatest. Other benefits for pensioners, such as winter fuel payments, would also be protected. However, the age at which the state pension could be claimed would rise to 66 for both sexes by 2020; sooner than planned by Labour.

The Coalition pledged to maintain the goal of ending child poverty in the UK by 2020. A reduction in tax credits for higher earners was also promised. Otherwise, comparatively few policies were agreed on working-age benefits. However, a commitment to "…investigate how to simplify the benefit system in order to improve incentives to work" proved to be the springboard for one of the Coalition's flagship policies: the planned unification of several means-tested benefits and tax credits to create a new Universal Credit system.

What did the Coalition do?

Personal tax changes

For income tax payers, the most important changes introduced by the Coalition were increases in their tax-free allowance. This rose in stages from £6,475 in 2010/11 to £10,000 in 2014/15 (and to £10,600 from April 2015). Compared to price-linked indexation, the policy was worth about £550 per year for most income taxpayers by 2014, although higher rate tax thresholds were adjusted to prevent higher earners benefitting from this (although they will do so in 2015/16).

The Coalition left in place Labour's new tax rule that withdrew personal allowances from those earning more than £100,000 a year. But it also set tighter limits on pension contribution tax relief, and imposed tax rules withdrawing Child Benefit where a parent had annual taxable income exceeding £50,000. From 2013/14, the 50 per cent marginal rate of tax on incomes above £150,000 that Labour had introduced was reduced to 45 per cent.

Uprating benefits and pensions

In the Coalition's first two years, a critical 'non-decision' affecting poverty and income inequality was initally to leave in place the system by which most benefits and state pensions were uprated annually with prices (using the Retail Prices Index, RPI). But the treatment of pensioners and other benefit claimants diverged sharply from 2012/13. Uprating most working-age benefits using the Consumer Prices Index (CPI) – which excludes housing costs and is calculated in a different way – means lower increases than using the RPI. On top of this, for three years after 2012/13, most working-age benefits were increased by only 1 per cent a year, below inflation (and with a further freeze planned from 2016). By contrast since 2011 pensions have increased by at least price inflation, or by earnings growth, if faster.

Benefit and tax credit reforms

Specific reforms and cuts to benefits and tax credits, many of which took effect from 2013, included:

- A cap of £26,000 a year on the total amount of benefits most working age families could receive.
- Tighter limits on Housing Benefit for private tenants, as well as cuts for social housing tenants of working age deemed to have spare bedrooms.
- A freeze on Child Benefit in cash terms for three years from 2011/12, and then a 1 per cent increase in 2014/15, representing a significant real terms cut. The 'family element' of Child Tax Credit was also frozen.
- Abolition of Child Trust Funds, introduced by Labour, from early 2011.
- A Council Tax freeze for most households, but reforms to Council Tax Benefit, which meant many low-income households paying more or paying part of the tax for the first time.
- Reforms to tax credits (such as abolition of the "baby element" in Child Tax Credit) that made them less generous, plus a faster rate of withdrawing credits as income increased.
- Tighter conditions and tougher administration arrangements for disability benefits.
- Abolition of most of the Social Fund which gave emergency grants and loans to people with low incomes. Councils were given responsibility for organising local support, but with a lower budget.
- Stricter administration of many out-of work benefits, including much greater use of 'sanctions' imposed on unemployed and other claimants for not meeting particular job-search requirements.

Pension reform

Alongside its 'triple lock' policy for uprating pensions, the Coaltion moved to further reform state pensions. This included the introduction of a flat rate 'single tier' pension to be paid to all those retiring from 2016. While designed to benefit many women and self-employed people, its zero net cost means that that others will receive less pension than under the existing system.

Changes to the state pension age were also accelerated. Labour's plan to raise the qualifying age to 66 by 2026 was brought forward to 2020 and plans were announced to accelerate a further increase to 67. Another major reform, affecting people with private pension pots, is the removal from April 2015 of a requirement to convert accumulated funds into retirement annuities, which pay a regular income for life.

Universal Credit

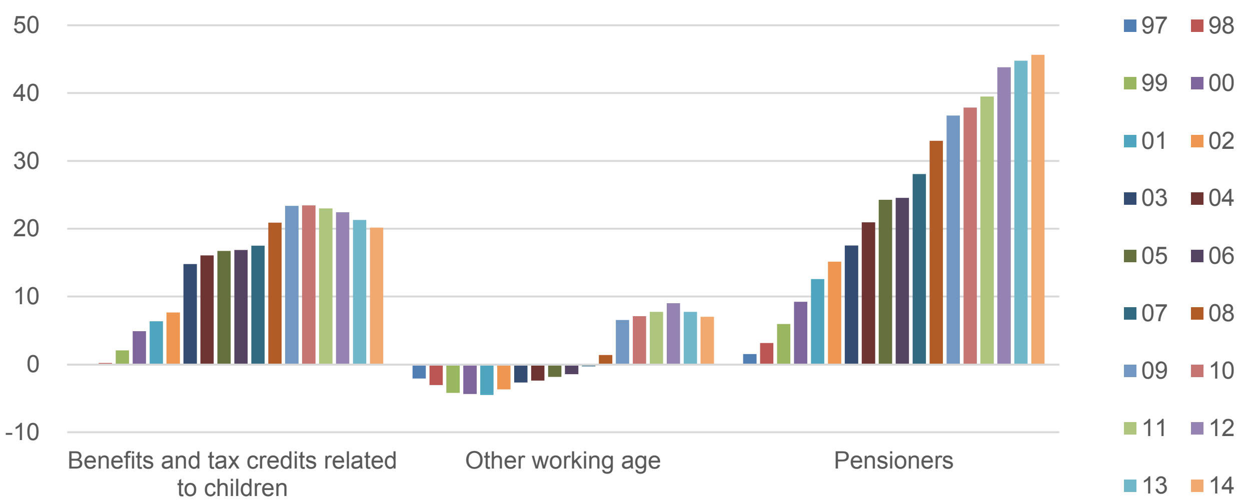
Universal Credit is designed to replace six means-tested benefits and tax credits (including Housing Benefit). Some 7.5 million households were originally expected to receive the new credit by 2017, which amalgamates support for people in and out of work. It also removes overlaps in means-testing and tax arrangements that can leave some benefit claimants facing marginal tax rates of 90 per cent or more if their incomes grow (although marginal tax rates increase for others). The new credit is paid monthly, instead of weekly or fortnightly. Entitlement is calculated in 'real time', based on actual income reported by employers. However, the introduction of Universal Credit has been slow, with only 18,000 people receiving it by October 2014, compared to the 2 million originally planned by then.

How much did the Coalition spend?

In 2009/10, Labour's last complete year, total spending on cash transfers for Great Britain was £182 billion, or 12.7 per cent of GDP. The following year, as the Coalition took office, spending rose to £184 billion (at 2009/10 prices), but fell to 12.5 per cent of GDP. By 2014/15 projected spending had reached £188 billion, but fallen further as a proportion of GDP to 12.1 per cent.

Figure 1 shows growth in real-terms spending since 1996/97 broken down between pensioners, payments relating to dependent children, and other working-age benefits. It shows that spending on pensioner benefits rose continuously under both governments. Transfers related to children increased until 2010/11, but then fell significantly. Spending on other working-age benefits and tax credits was lower in 2007/08 than in 1996/97, but then grew as the recession took hold, peaking in 2012/13.

Figure 1: Real spending on pensioners continued to rise, but it fell for children after 2010/11

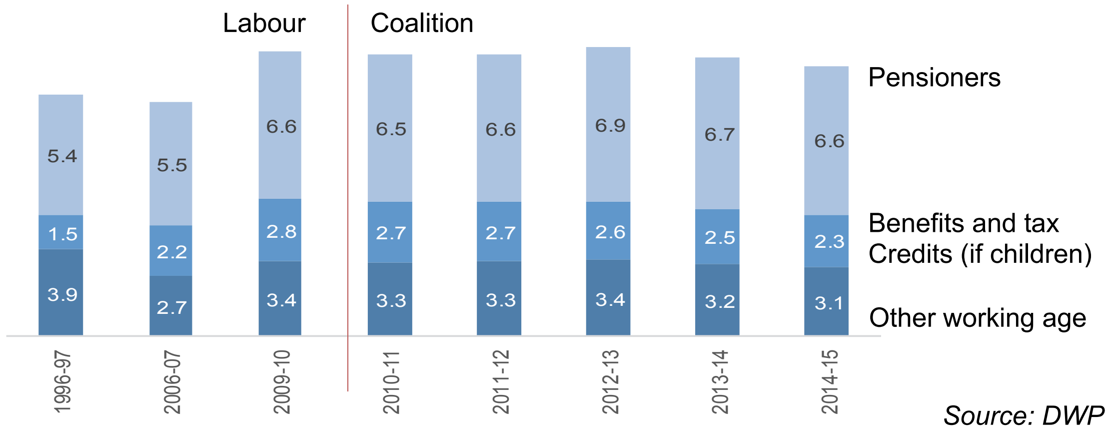


Source: DWP data (£ billion, 2009-10 prices, GB). Figures show change from 1996/97 in years from 1997/98.

As a share of national income, the cost of working-age benefits that were not related to having children fell under Labour from 3.9 per cent of GDP in 1996/97 to 3.4 per cent in 2009/10, and then further under the Coalition to 3.1 per cent. This downward trend also applied to their share of overall public spending. Figure 2 also shows that spending related to children rose from 1.5 to 2.8 per cent of GDP over the Labour years, but fell back to 2.3 per cent of GDP by 2014-15. As a share of national income, transfers to pensioners increased from 5.4 per cent of GDP in 1996-97 to 6.6 per cent in both 2009-10. This was also the proportion in 2014-15, although a peak of 6.9 per cent was reached in 2012-13.

OECD league tables show that the UK remains a relatively low spender on cash transfers compared with other industrialised countries. In 2009 it was 19th out of 30 member countries, below France and Germany, but above the Netherlands and the USA. In 2013 it was placed 18th equal.

Figure 2: Cash transfers to working age people fell under Labour and Coalition as % GDP



Source: DWP data.

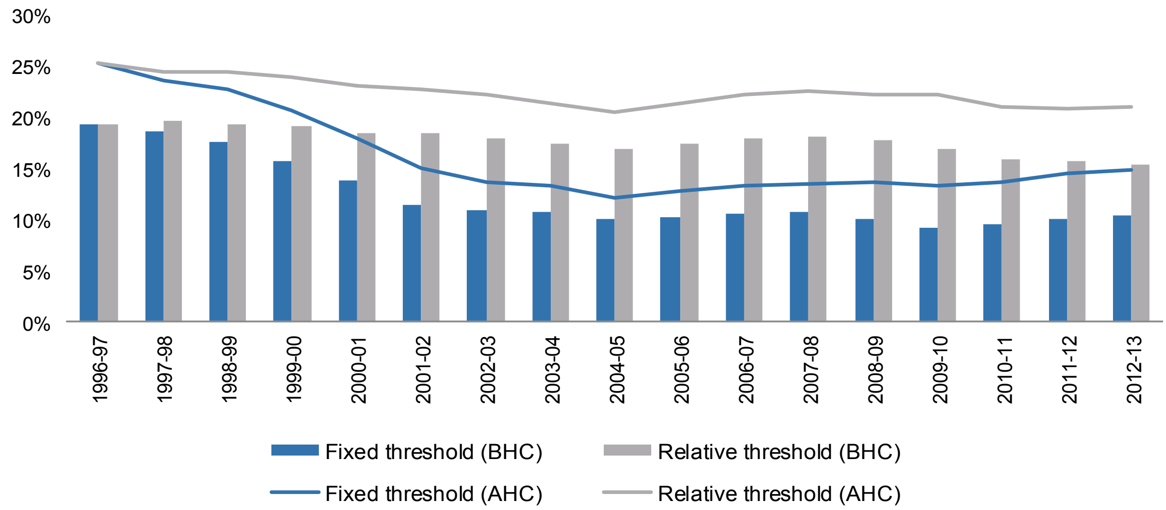
What was achieved?

Statistics are currently only available for the combined results of the recession and policy changes up to half-way through the Coalition's term of government, the financial year 2012/13. This preceded many of the benefit and tax credit cuts described above, several of which started in April 2013. They also only take account of the first year when many working-age benefits were increased by less than inflation.

Benefit uprating in the Coalition's early years combined with the recessionary squeeze on earnings to reduce relative poverty, but poverty rose against a fixed line

Inflation-linking of benefits in the Coalition's first two years continued while real earnings fell in the wake of the economic crisis. This, while it lasted, reduced income inequality and relative poverty. Government statistics for *Households Below Average Income* available up to 2012/13 show that, before allowing for housing costs, relative poverty (using the standard definition of people living in households with less than 60 per cent of median net income) fell between 2009/10 and 2010/11 and was generally flat in the following two years to 2012/13. However, when assessed against a fixed threshold, poverty increased (Figure 3). The reason why fewer people lived in households that were relatively poor was that real earnings for those in the middle of the income distribution had fallen. Taking account of housing costs, the statistics reveal a similar story, but suggest that poverty against a fixed line grew even faster.

Figure 3: Relative poverty fell in the election year, but the population below a fixed income threshold (60 per cent of 1996/97 median income) has been rising since 2009/10



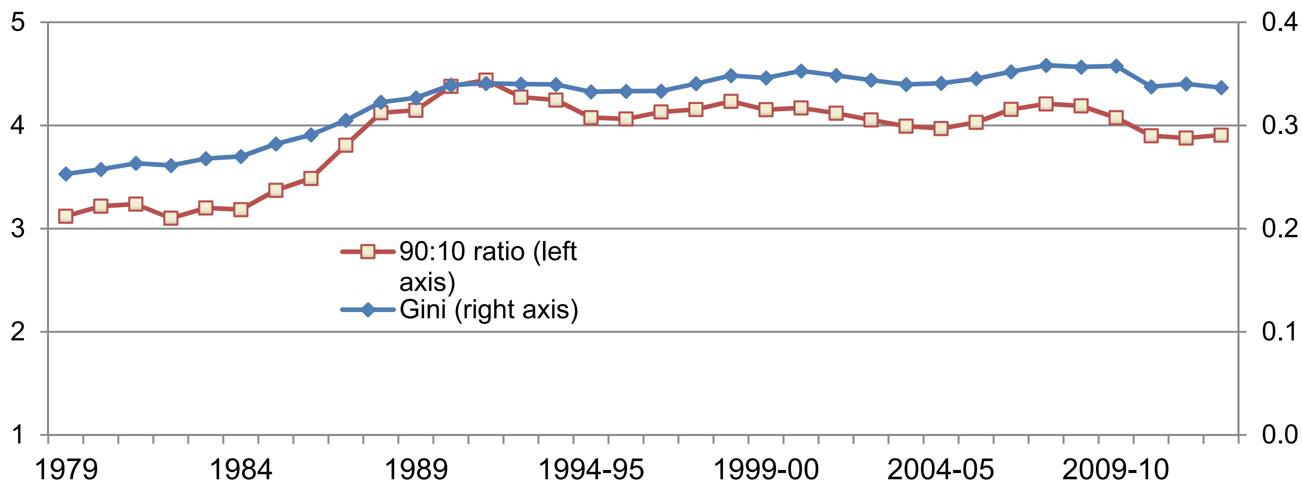
Source: DWP/IFS Households Below Average Income analysis.

In addition, changing food and fuel prices affected those with low incomes most. ONS shows that prices rose 1.5 per cent more for the poorest tenth between 2011 and 2013 than the CPI, while the cost of items in the 'minimum income standard' rose about 7 per cent more than the CPI from 2008 to 2014. Alongside the specific benefit changes since 2013 this implies that living standards will have fallen – and hardship risen – faster at the bottom than suggested by the figures adjusted for general inflation.

Income inequality

Conclusions about inequality trends during the first part of the Coalition's term in office depend, critically, on whether the base for assessing its record is taken as 2009/10 (Labour's last full year in government), or 2010-11 (when they took power). Two different measures of income inequality (the Gini coefficient and the 90:10 ratio) both show inequality falling between 2009/10 and 2010/11, before flattening out. As previously noted, this happened because incomes higher up the distribution fell in real terms, while those at the bottom were protected – for the time being – through price-indexation of tax credits and benefits.
If 2009/10 is used as the base for measurement it can be argued that inequality fell at the start of the Coalition government. If 2010/11 is taken as the base, it was flat. Setting aside any arguments over which administration should claim credit, income inequality from 2010/11 to 2012/13 was as low as it had been at any time since before Labour came to office.

Figure 4: Income inequality fell sharply in 2010/11 before flat-lining for the next two years



Source: Institute for Fiscal Studies (figures shown before housing costs).

Savings from benefit cuts balanced out tax allowance increases and the "triple lock" on pensions

Although survey results have a time lag, it is possible to model the consequences of Coalition policies on taxation and cash transfers through to 2014/15. Figure 5 assesses the effects of *direct* tax, tax credit and benefit changes across the income distribution compared with simply uprating the system left by Labour using consumer price inflation (CPI). Remarkably, given the Government's commitment to deficit reduction and austerity, it shows that the overall changes were fiscally neutral (although *indirect* tax changes, like higher VAT, not included here, raised revenue). Savings were achieved through less generous benefits and tax credits. But these were offset by the high cost of delivering its commitment to raise the income tax allowance to £10,000, as well as lower average Council Tax and state pensions rising faster than CPI-inflation under the "triple lock".

The combined impact of direct tax and cash transfer changes was mostly regressive, moving income from poorer households to those that were better off

The Coalition's policy changes had substantial distributional effects. The poorest twentieth lost nearly 3 per cent of their incomes on average (not allowing for VAT and other indirect taxes) and the next five-twentieths lost approaching 2 per cent. Within those averages there were differences: for example within the poorest tenth, one in four lost more than 5 per cent of their income, but one in ten gained more than 5 per cent. With the notable exception of the topmost twentieth, income groups in the top half were net gainers from the changes. The effect was largely regressive because the impact of benefit reductions was greater for those in the bottom half of the income distribution than any gains from lower income tax. However, at the top of the distribution, the net effect was a loss as a result of other changes, such as a lower threshold for higher rate tax and withdrawal of Child Benefit. Yet even here, the topmost one per cent remained narrow gainers thanks to the cut in the highest tax rate from 50 to 45 per cent.

Figure 5: Percentage changes in household disposable income due to direct tax and tax transfer policies (May 2010 to 2014/15)

Source: De Agostini, et al (2014)/EUROMOD. Figures show percentage change in household disposable income by income group due to policy changes, compared with May 2010 system uprated by CPI.

This analysis omits indirect taxes and some other taxes. Modelling by the Treasury and the Institute for Fiscal Studies, taking account of indirect tax rises, also shows that policy changes were regressive between the bottom of the income distribution and the seventh or eighth tenths. But if the timescale includes Labour's changes just before the election (such as the 50 per cent top rate) affecting the highest incomes, the percentage loss for the top tenth was greater than for other groups.

Projections point to continuing redistribution of income away from poorer households and increased child poverty by 2020

Some Coalition policies will have their main effects over the longer term. These include:

- The new basis for uprating pensions, benefits and tax credits from year to year (CPI-indexation for most, but a continuing "triple lock" for pensions) and a two-year cash freeze in many working-age benefits from 2016.
- A further real increase in personal income tax allowances, more favourable treatment for some married couples, and changes in the tax treatment of savings and childcare.
- The full introduction of Universal Credit.
- Introduction of the new single tier state pension for those reaching state pension age from 2016, and other pension reforms.

Analysis taking the first three of these into account suggests that they will generally reinforce the regressive effect shown in Figure 5. However, if Universal Credit succeeds (as intended) in boosting claims from those who currently do not get all the benefits they are entitled to, the poorest tenth could emerge as net gainers. Alternatively, if Universal Credit is perceived as more stigmatising than existing benefits, this could go the other way. Modelling by the Institute for Fiscal Studies suggests there will already have been a sharp rise in relative poverty (and in poverty against a fixed line) between 2012/13 and 2014/15 for children and for working-age non-parents, and then a further rise to 2020/21, with the relative child poverty rate reaching 21 per cent, up 3.5 percentage points from 2012/13.

Conclusions

The Coalition's policies affecting cash transfers fall into three phases. Continued real-terms protection of benefits in the new Government's first two years shielded the incomes of those at the bottom at a time when real earnings were falling. This helps explain why inequality and relative poverty fell between 2009/10 and 2010/11 and were then flat until 2012/13, while poverty against a fixed real line rose.

But modelling suggests that over the whole of the Government's term to 2014/15, the dominant feature has been that non-pensioners with lower incomes on average lost more from benefit and tax credit cuts than they gained from increased income tax allowances. The reverse was true for most income groups above the middle (but not those right at the top). These changes generally transferred income from those in the bottom half of the income distribution (and some right at the top) to those in the top half of the distribution, rather than contributing to deficit reduction.

In the longer term the different indexation methods that the Coalition has used to uprate benefits, tax credits and pensions will continue to tilt policy in favour of pensioners, in a break from Labour's policies, which had favoured families as well. Child poverty is expected to have risen by 2014/15 and to increase further in the next five years. This takes the projected trend in the opposite direction to abolition of child poverty by 2020 – the target that the Coalition had endorsed in 2010.

Other aspects of the policy landscape remain uncertain. These include the speed of introduction of Universal Credit and whether it succeeds in raising take-up for current non-claimants, and the effects of deregulation of the use of private pension pots from 2015. Other uncertainties include the impact of income tax and social security devolution to Scotland and benefit restrictions imposed on new immigrants. If further 'welfare cuts' beyond those already agreed became part of deficit reduction following the 2015 General Election, losses at the bottom would be increased.

Further information

The full version of this paper *The Coalition's Record on Cash Transfers, Poverty and Inequality 2010-2015* is available at http://sticerd.lse.ac.uk/dps/case/spcc/WP11.pdf This is one of a series of papers produced as part of CASE's research programme *Social Policy in a Cold Climate* (SPCC). The research, concluded in 2015, examines the effects of the major economic and political changes in the UK since 2007, focusing on the distribution of wealth, poverty, inequality and social mobility.

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