



Conservative manifesto tax policy and Universal Credit

Introduction

At the Conservative party conference in October 2014, the Prime Minister David Cameron committed his party to two important income tax cuts should they be re-elected; an above-inflation increase in the personal allowance, the amount of income that can be earned before paying tax, and an above-inflation increase in the higher rate threshold, the amount of income that can be earned before paying the 40 per cent higher rate of income tax. This commitment has been repeated in the Conservative election manifesto.

A real increase in the value of the personal allowance of the kind proposed by the Conservative party suggests a continuation of the current government's tax policy, which saw the personal allowance rise by over 60 per cent between 2010/11 and 2015/16. A real increase in the higher rate threshold, however, would signal a change of direction from the current parliament where the HRT has been held to below-inflation increases.

The current coalition policy on the personal allowance has been justified as reducing the tax bill of the lowest-paid workers. Indeed, during his speech on the 1st October 2014 David Cameron said the Conservatives proposals for the next parliament would take one million of the lowest paid workers out of tax. But he also said it would act as a tax cut for a further 30 million workers. This points to the central problem of using the personal allowance as a strategy for boosting after-tax income; it benefits so many workers that it is very expensive in terms of lost tax revenue, while also providing no income boost to those workers already in work but earning less than the personal allowance.

In addition, Universal Credit, the new in-work benefit rolling out nationally in the next parliament, is calculated on post-tax income, so any rise in the personal allowance will also reduce entitlements for low-paid workers. This means those claiming Universal Credit will not receive the full benefit of personal allowance increases.

Real increases in the Higher Rate Threshold are likely to have an even starker distributional impact – only benefitting the minority of workers earning over the current higher rate threshold, a group that is in the top fifth of the earnings distribution. And, taken together, dual earner households will receive the biggest benefit from these proposed changes, with lone parent families and other single households gaining less.

This note looks at the distributional impact and cost of these two tax cuts, should they be implemented over the next parliament. Given that these cuts represent a significant fiscal cost, we also look at an alternative use of comparable funds that could better achieve a similar aim; raising the incomes of low-paid workers.

The Conservatives' proposed tax cuts

The two tax cuts proposed by the Conservatives are;

- Raising the personal allowance from its current level of £10,000 to £12,500 over the next parliament. It is worth noting that the personal allowance is already legislated to rise by £600 from this April. The conservative proposal therefore involves a further move from £10,600 to £12,500. At the 2015 budget, the Chancellor set out a further increase to £10,800 in 2016/17 and then £11,000 in 2017/18. The remaining rise of £1,500 will presumably be carried out in stages between 2018/19 and 2020/21, the last year of the next parliament.
- Raising the higher rate threshold to £50,000 over the next parliament. In 2015/16 the higher rate threshold is expected to rise from £41,865 to £42,385 (the £10,600 tax-free personal allowance plus the £31,785 basic rate band in which workers pay income tax at 20 per cent). In the 2015 budget, the chancellor detailed the path of the higher rate threshold out to 2017-18, when it will reach £43,300. It is likely that the Conservatives plan to reach £50,000 in 2020/21, the last year of the next parliament.

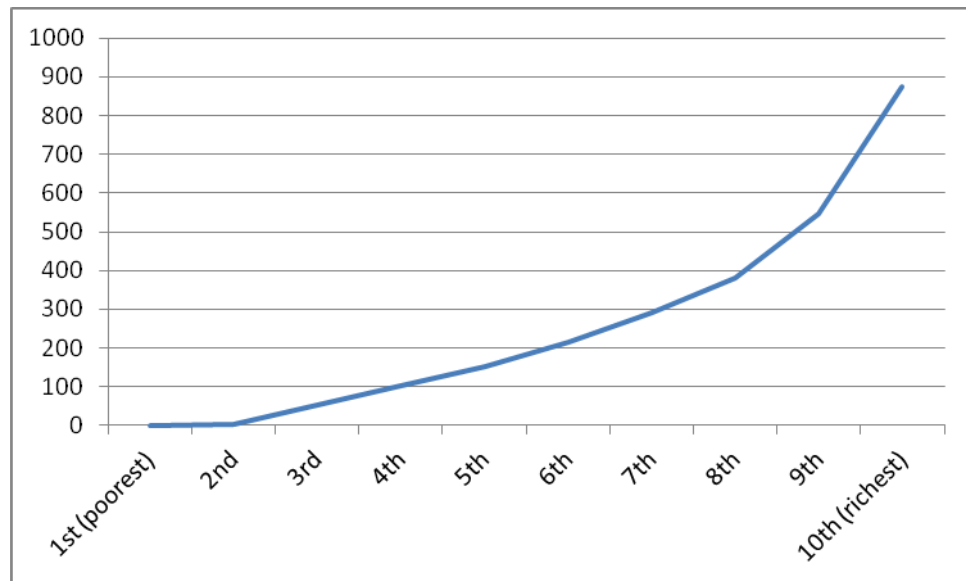
In the absence of discretionary changes such as those proposed by the Conservatives, the PA and HRT automatically rise by inflation each year. This means not every pound of the increases outlined above should be viewed as a tax cut. Under the OBR's March 2015 projections of CPI inflation, we would expect the PA to reach £11,390 and the HRT to reach £45,480 by 2020/21. Therefore the Conservatives proposals are for a £1,110 increase in the PA and a £4,520 increase in the HRT.

This implies that the maximum benefit a basic rate taxpayer can expect from the additional personal allowance increase is £222 per year, the maximum benefit for a higher rate taxpayer would be £1,126.

A taxpayer earning between £50,000 and £100,000 (the level of income at which the personal allowance starts being tapered away) would enjoy the full benefits of both changes, seeing their after-tax income rise by over £2,000 per year relative to what their income would be should both tax brackets only be up-rated by inflation.

Figure one shows the combined distributional impact of both Conservative tax cuts. The chart shows the average change in annual income, in 2020/21 prices, in each decile of the equivalised family income distribution from the first (poorest), to the 10th (richest).

Figure 1: Average change in annual income (2020/21 £) by equivalised family income decile, from Conservative tax proposals



Source: Family Resources Survey 2012-13

It shows that the higher a family is up the income distribution, the greatest they are likely to gain from the Conservatives proposed tax changes. Those in the 10th decile gain almost £900 a year on average, whereas those in the bottom two deciles gain only marginally; those on the lowest incomes are likely to be out of work (or earning very low wages which mean they are already below the existing personal allowance threshold), meaning they receive no benefit from changes to the personal allowance. Those in the 9th and 10th deciles see substantially higher gains than those in the middle of the income distribution. This is likely to be because those two deciles contain the majority of higher-rate taxpayers, who see a benefit from both the rise in the personal allowance and the increased higher rate threshold (other than the small number of individuals earning over £120,000 per year, who do not benefit from a rise in the personal allowance).

How much would these tax cuts cost? At the time of their announcement, the Institute for Fiscal Studies suggested the total cost in terms of lost tax revenue from the proposals would be £7.2bn. But this was based on forecasts of inflation and their impact on tax bands made by the OBR at the time of the March 2014 budget. Given that the OBR revised their forecasts of inflation down at both the December 2014 Autumn Statement and March 2015 budget, we estimate that the cost of these tax cuts has risen to £8.9bn.

An alternative proposal – strengthening Universal Credit

Given the sizable cost of the Conservatives' proposals for tax cuts, it is worth exploring other policies to boost the incomes of workers that require a similar level of funding. One way in which workers, and the low-paid in particular, could be better served would be through strengthening the components of Universal Credit, the new benefit that combines six different benefits and will be rolled out nationally in the next parliament.

Universal Credit rolls together six different existing benefits into a single payment. Important features of the Universal Credit include:

- **Basic award:** the core element of Universal Credit, based on age and single/couple status
- **Additional elements:** in addition to the basic award, families can be eligible for additional amounts depending on their circumstances, such as their disability status and the presence and number of children.
- **Work allowances:** Universal Credit allows recipients to earn up to a given level of income before their Universal Credit award begins to be tapered away at a rate of 65 pence for every extra pound earned. These allowances vary based on family circumstance such as the number of adults, number of children and disability status, as well as being higher for those claiming the housing costs element of Universal Credit.

Universal Credit could be made more generous by increasing the basic or additional elements, or by increasing the value of the work allowance.

In addition, there are two important flaws in the design of Universal Credit that could be rectified with additional resources:

- **Second earners:** under the current design of Universal Credit, an out of work partner in a family claiming universal credit but with current earnings higher than the work allowance will see their Universal Credit award tapered away from the first pound earned, should they move into work. This means they face only a marginal increase in income from moving into work.
- **Low hours:** under the current design of Universal Credit, for many families and levels of earnings there is little incentive to increase hours of work, with UC designed more to reduce worklessness among families, rather than supporting them to increase their hours of works once claiming.

Two proposals have been suggested to combat these flaws:

- **Introducing a second earners disregard:** introducing an additional work allowance for second earners would allow out of work partners to keep more of their income should they move into work
- **Introducing an hours bonus:** awarding UC recipients an additional sum if they work over a set number of hours would reward increasing hours of work within the UC system

In order to assess the cost and distributional impact of a variety of changes to the UC basic and additional elements, as well as the introduction of a second earner

disregard and an hours bonus, we have modelled a variety of reforms to universal credit;

- Raising the additional child element of universal credit by £80 per month by 2020/21
- Raising the additional element for those with a limited capability for work (LCW) by £80 per month by 2020/21
- Raising the work allowances by 20 and 30 per cent by 2020/21
- Introducing a second earner disregard set at 50 per cent of the work allowance
- Introducing an hour bonus of £40 a month for those working at least 16 hours (in 2020/21)

We have grouped these reforms into four packages;

Option one: Higher additional child element, 20 per cent higher work allowances, second earner disregard set at 50 per cent of the work allowance

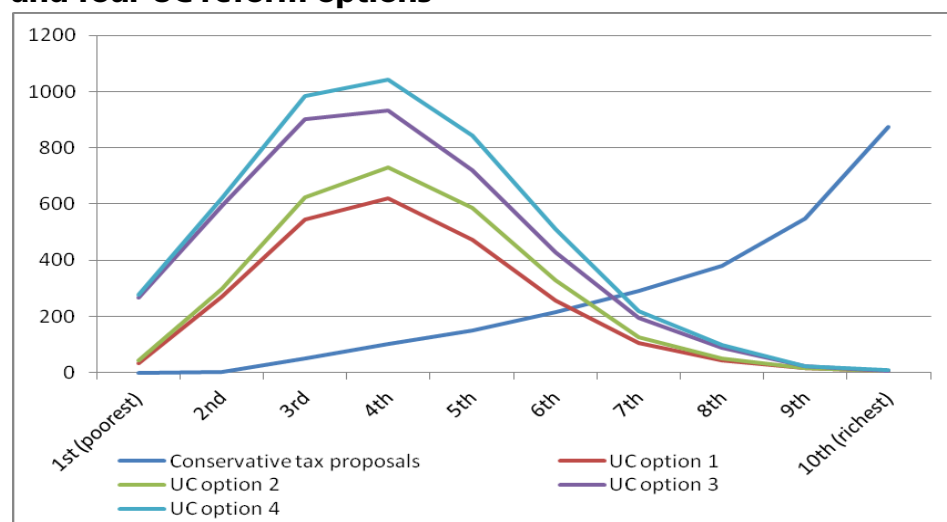
Option two: Higher additional child element, 30 per cent higher work allowances, second earner disregard set at 50 per cent of the work allowance

Option three: Higher child and disabled amounts, 20 per cent higher work allowances, second earner disregard and hours bonus

Option four: Higher child and disabled amount, 30 per cent higher work allowances, second earner disregard and hours bonus

How does the distributional impact of these reform packages compare to the Conservatives proposed tax cuts? Figure 2 sets out four sets of options for reforming Universal Credit, the first two costing broadly comparable amounts to the Conservative plans, and the second two which cost around £4bn a year more (see below).

Figure 2: Average change in annual income (2020/21 £) by equivalised family income decile from Conservative tax proposals and four UC reform options



Source: Family Resources Survey 2012/13

Table 1: Average change in annual income (2020/21 £) by equivalised family income decile from Conservative tax proposals and four UC reform options

	Conservative tax cuts	UC option one	UC option two	UC option three	UC option four
1st (poorest)	0	34	45	267	279
2nd	2	271	297	593	620
3rd	51	543	623	903	983
4th	102	619	729	931	1044
5th	151	473	587	719	842
6th	214	256	327	430	511
7th	291	106	127	194	218
8th	381	43	52	87	98
9th	548	15	17	22	25
10th (richest)	875	6	7	8	9

Source: Family Resources Survey 2012/13

This shows that, unlike increases in the personal allowance and higher rate threshold, those in the bottom half of the income distribution gains the most from each of the proposed UC reform packages. Those in the fourth decile, for example, would gain between £600 and £1000 on average from the UC reforms, instead of around £100 under a higher personal allowance. And, unlike the tax cuts scenario, those on the highest incomes gain very little from changes to UC, with those in the 8th-10th decile receiving well under £100 from a more generous UC system.

While it is still true that those on the very lowest incomes gain relatively less than those in the 2nd-6th deciles, as they are more likely to be out of work and will not benefit from higher work allowance, they nonetheless will receive more than they would do under the Conservatives proposed tax cuts (and those with children would likely receive more than the average amount). In particular, a more generous limited capability for work element substantially increases the gains to those in the bottom decile to over £250 a year on average.

The cost of these options is set out below, alongside the cost of the Conservatives proposed tax cuts. This shows that option two could be implemented for a similar fiscal outlay as the Conservative's tax cuts proposal, and option one would be slightly cheaper. Both would provide far more help to low and middle earning households.

Table 2: Proposal costs

	Cost (2020/21 £bn)
Conservative proposal	8.9
UC option one	7.5
UC option two	9.0
UC option three	13.1
UC option four	14.7

Conclusion

The Conservative's proposed tax cuts are very expensive and highly regressive. They are poorly targeted, with the biggest gains going to the highest income households and little to no gain for those in the bottom half of the income distribution.

The £8.9 billion that the Conservatives plan to spend on tax cuts in the next parliament would be better invested into making Universal Credit more generous. For a similar fiscal outlay, Universal Credit could be improved to provide better work incentives for second earners, more support to families with children and allow recipients to keep more of their earnings. This would be a fairer, more progressive option for reform in the next parliament, and a far better use of scarce fiscal resources than expensive tax cuts.