

# The impact of benefit and tax uprating on incomes and poverty

Findings  
Informing change

April 2008

Each year, the Government decides how much to raise benefits and tax allowances. The basis for these upratings is rarely debated, yet has major long-term consequences for the relative living standards of different groups and for public finances. This research considers the implications of present uprating policies, and aims to stimulate debate on this hidden area of policy-making.

## Key points

- Different uprating methods are applied to different parts of the tax and benefit system, including uprating in line with earnings, uprating with inflation and no uprating at all.
- Uprating policies have big effects over time. For example, it will be virtually impossible for the government to end child poverty if payments for families with children rise more slowly than average household incomes. Over 20 years, the consequences of current uprating policies, other things being equal, would be to:
  - Almost double the rate of child poverty, from 18% to 33%. However, it would have little effect on pensioner poverty because pensioner benefits will be largely earnings-linked from 2012.
  - Reduce the value of benefits and tax credits, relative to earned incomes (*benefit erosion*).
  - Increase the percentage of incomes taken in tax revenues, by raising tax thresholds more slowly than earnings (*fiscal drag*).
  - As a result, improve the public finances by an amount equivalent to 3.6% of national income (£47 billion at today's levels).
  - Reduce disposable incomes (relative to earnings), but far more for the poor than for the rich. The poorest households would lose on average 17% of disposable income; the richest households 5%.
- Governments may use money raised by benefit erosion and fiscal drag to pay for public spending in other areas, including ad hoc benefit increases. However, some of the extra resources could be used to systematically uprate the value of benefits and tax credits faster. This would spread the impact of erosion and drag more evenly across all levels of income, reducing poverty rates.

## The research

By a team from Essex University, London School of Economics and Universities of Oxford and East Anglia.

## Background: why is uprating important?

Annual adjustments of benefit, tax credit levels and tax thresholds can seem like a technical exercise, scarcely noticed among announcements made in Budgets. In reality, they are among the most significant decisions taken by Chancellors. As with climate change, their gradual effects seem imperceptible on a year-to-year basis, yet they carry immense implications for the future.

The aim of this research is to make more visible the scale and implications of current uprating conventions against some alternatives, for income distribution, poverty rates and the public finances.

Different criteria are used in uprating different parts of the UK benefit and tax systems:

- Since the 1980s, most benefit levels and tax thresholds have been uprated annually by the Retail Prices Index (RPI) measure of inflation.
- Means-tested benefits are uprated by the 'Rossi' inflation index, which excludes housing costs and local taxes, on the basis that these costs are supported directly.
- A few elements – such as the Guarantee Credit for pensioners and (until 2009) the child rates within the Child Tax Credit – are adjusted by average earnings.
- Some parts of the system – such as capital limits and earnings disregards in Income Support – are not uprated at all and have had the same nominal value for years.

Which index is used can make a big difference. For example, if the amount of Jobseeker's Allowance (or its equivalent) received by a single unemployed person had kept pace with average earnings since 1971, it would be double the value it is now.

Uprating rules have particular relevance for the prospects of meeting the present government's child poverty targets in 2010 and 2020, especially those poverty targets for the proportion of children with household income less than 60% of median income. If median (middle) income rises faster than benefit incomes, poverty reduction will be virtually impossible to achieve.

## Principles and practice

A number of different principles might guide uprating practice. These are summarised in Table 1.

A review of practice in other countries reveals that no single principle seems to govern uprating procedure. Instead, uprating involves compromise between a number of objectives and policy can fluctuate year-to-year as conditions and political priorities change.

In practice, uprating decisions can be used not only to maintain the status quo, but also to adjust the value of benefits or tax thresholds over time where a government thinks that their present level is too high or too low. This can provide a way of phasing in structural changes slowly, minimising disruption to household budgets. But it can also disguise the losses affecting some people and confuses the arguments for regular uprating.

**Table 1: The aims and effect of different uprating factors**

Aim	Choice of uprating factor
Maintain current inequality	Average income (e.g. mean after-tax income)
Maintain current relative poverty	Typical incomes (e.g. median household income, as used to define the poverty line)
Keep up with a Minimum Income Standard	Change in income necessary to achieve a contemporary budget standard
Maintain real standard of living	Relevant price index (e.g. Retail Prices Index (RPI), Rossi or Consumer Price Index)
Constant return on contributions	Gross earnings
Public finance affordability	National income (GDP)
Coherence	Common uprating factor across the whole tax-benefit system
Government flexibility	None

## The impact of different uprating systems

To create greater clarity about the long-term effects of different uprating regimes, this research considered what would happen over a 20-year period from 2006/7 under various policy scenarios, if everything else stayed the same. The study assumed 2% per year annual real growth in earnings in line with recent experience. This is not a forecast of the future, since it does not take into account future policy responses or demographic change. It is a way of separating out the specific effect of different uprating options over an extended period.

### Effect under present conditions

The 'base case' for such calculations is the current uprating system. Under this scenario, after 20 years:

- Uprating of the income tax personal allowance in line with prices would leave it 33% lower than in 2006/7, relative to earnings.
- The family element of the Child Tax Credit (frozen) would be worth 62% less, relative to earnings.
- The basic State Pension (indexed to prices until 2012 and then by earnings) would be worth 9% less whereas the Pension Credit Guarantee (indexed to earnings) would be worth the same as it is now in relative earnings terms.

### Effect on poverty

Not surprisingly, with benefits falling sharply in relative terms, other things being equal the percentage of people in relative poverty (in households with below 60% of median income before housing costs) would rise in this scenario: from 17% to 23% of the population. (The rise when measuring income after housing costs is similar – from 21% to 25%.)

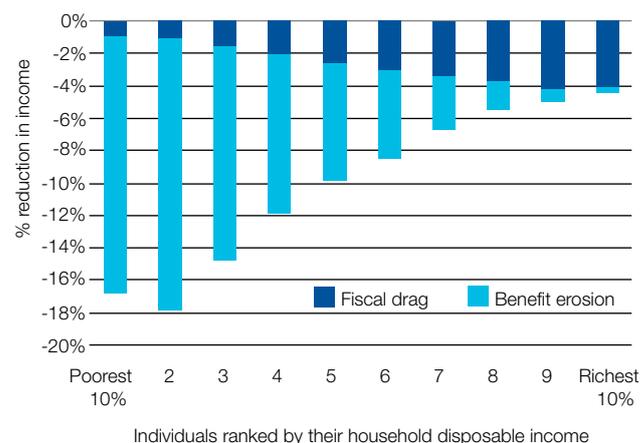
This would, however, affect different groups very differently. Pensioners would see no substantial change in their poverty rate as they will be protected by upratings linked to earnings. However, child poverty would rise dramatically, from 18% to 33% on the Government's preferred measure (before housing costs). Thus, instead of eradicating child poverty, the effect of continuing current uprating policies would be almost to double it.

Moreover, among people in all groups who fall below the poverty line, the depth of poverty would rise. In particular, the average incomes of people in poverty after housing costs would be less than two thirds of income at the poverty line (65%) compared to more than three-quarters (77%) today.

### Effect on the public purse

Overall, the budgetary effect is a substantial gain to the public finances, compared to what would happen if the

**Figure 1 The impact of fiscal drag and benefit erosion in 20 years' time, based on present policies**



Source: POLIMOD using FRS 2003-04

system was adjusted in line with earnings growth. After 20 years this amounts to around 3.6% of GDP, or the equivalent of £47.4 billion relative to 2006/7 earnings. More than half (£27.2 billion) is due to the erosion in the value of benefit and tax credit amounts and thresholds relative to earnings, with the remainder being due to fiscal drag.

### Distributional effects of fiscal drag and benefit erosion

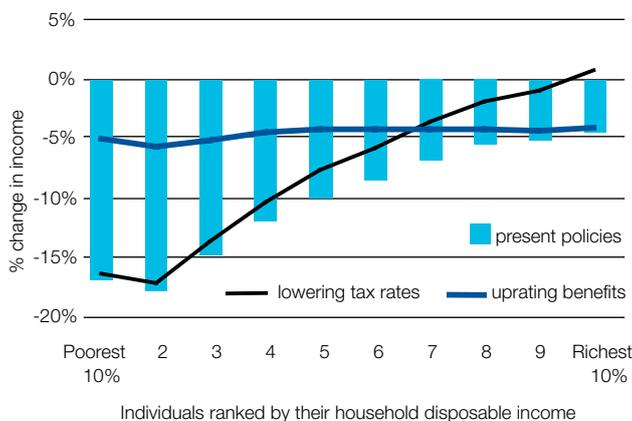
As shown in Figure 1, benefit erosion plays a much bigger role than fiscal drag at the bottom of the household income distribution, and the reverse is true at the top end. In combination, they result in a proportional reduction in incomes that is nearly four times as large for the poor as the rich. The 20% of households with the lowest incomes on average lose 17% of their disposable income relative to earnings. The 20% of households with the highest incomes lose 5%.

### Alternative scenarios

Some of the potential gain to the public finances implied by the present uprating systems may be needed to fund extra government spending. In an ageing society, spending on the health service may need to rise as a percentage of national income, while spending on items such as pensions and long-term care will need to cover growing numbers of older people. Nevertheless, alternative ways of using the remainder would have very different distributional effects.

As an illustration, the researchers considered different ways of using £20 billion of the £47 billion budgetary gain. This would be enough to eliminate all the fiscal

**Figure 2 The distributional impact of spending £20bn on tax cuts or benefit uprating after 20 years of present policies**



Source: POLIMOD using FRS 2003-04

drag shown in Figure 1. It would allow, for instance, income tax rates to be cut over 20 years by gradually lowering the basic rate of tax from 20% to 17.6%. This might have superficial political attraction and would wipe out the losses of the highest earners but would have virtually no effect on the losses sustained by the poorest groups, as shown in Figure 2.

Alternatively, if £20 billion were used to uprate benefits faster than prices, bringing them closer to earnings growth, the effect on the poorest groups would be reduced sharply. Under this scenario, the costs would be similar at about 5% across income groups. Poverty would still rise, but only slightly – from 17% to 18% overall. If revenue gain is required by government over the medium term, this would be a much more evenly balanced way of achieving it.

## Conclusion

The modelling conducted for this report has shown that today's uprating systems imply substantial long-term reductions in personal disposable incomes relative to earnings. While all groups will be affected, those with the lowest incomes will be hit hardest, causing widening economic inequality. Some or all of the extra money raised may be needed for public spending to pay for demographic change and improving services. However, the raising of these funds appears unfair, falling disproportionately on poorer groups. A more open debate about this often hidden area of public policy may lead to different choices about how much extra money is needed and who should pay for it. Above all, this would mean that decisions that prevent the poorest members of society from keeping up with rising living standards would not be taken in the dark.

## About the project

This study used three types of micro-simulation modelling to establish the effects of alternative uprating regimes after 20 years. POLIMOD, Holly Sutherland's tax-benefit model based on Family Resources Survey (FRS) data, is used to estimate the effects for the UK population on incomes, poverty, work incentives and reliance on means-tested benefits, on the basis that everything apart from taxes, benefits and tax credits, remains the same. CARESIM, Ruth Hancock's model of pensioner incomes and long-term care, is also based on FRS and is used to focus on the effects on groups of pensioners, allowing for differences in income composition across groups and over time. LOIS, Martin Evans' model of hypothetical families, is used to illustrate the evolution of incomes for particular families over the 20 years being considered.

## For further information

The full report, **The impact of benefit and tax uprating on incomes and poverty** by Holly Sutherland, Martin Evans, Ruth Hancock, John Hills and Francesca Zantomio is published by the Joseph Rowntree Foundation. It is available as a free download from [www.jrf.org.uk](http://www.jrf.org.uk).

Published by the Joseph Rowntree Foundation, The Homestead, 40 Water End, York YO30 6WP. This project is part of the JRF's research and development programme. These findings, however, are those of the authors and not necessarily those of the Foundation. ISSN 0958-3084

Read more Findings at [www.jrf.org.uk](http://www.jrf.org.uk)

Other formats available.

Tel: 01904 615905 email: [info@jrf.org.uk](mailto:info@jrf.org.uk)