

7. The distributional effects of tax and benefit reforms since 1997

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Summary

- Tax and benefit changes under Labour to date will have a net cost to the exchequer of around £1.1 billion in 2005–06. This is the difference between a large set of changes raising around £57.2 billion and a slightly larger set of changes costing £58.3 billion.
- Tax and benefit reforms implemented in Labour's first term cost a net £4.8 billion, while those since 2001 have raised a net £3.7 billion.
- The average impact of the £1.1 billion tax and benefit giveaway since 1997 is to raise household disposable incomes by £0.84 a week or 0.2%. The biggest proportionate gains are in the second-poorest tenth of the population, whose disposable incomes are increased by 10.8%, while the richest tenth fare worst, with a cut in income of 5.1%.
- Tax and benefit reforms since 1997 have clearly been progressive, benefiting the less-well-off relative to the better-off. Reforms in the second term – while less generous on average – were more progressive than those in the first, with the poorest faring better.
- Increases in council tax above inflation since 1997 will raise a net £5.8 billion for local government in 2005–06, net of council tax benefit. This outweighs the £0.84 a week net giveaway per household by central government and leaves households overall £3.62 a week worse off on average.
- The increase in council tax is regressive, except for the poorest fifth of the population (thanks to council tax benefit). But the impact of council tax on the relative distribution of income is modest, leaving the overall progressive pattern of tax and benefit changes since 1997 intact.

7.1 Introduction

The two successive Labour governments that have been in power since May 1997 have each carried out many reforms to the tax and benefit system in the UK. These have not affected all groups in the population equally. Rather, gains or losses depend on people's income, age and

household circumstances. The aim of this chapter is to gain a deeper understanding of how tax and benefit reforms since 1997 have affected different groups in the population.¹

In Section 7.2, we outline the main tax and benefit reforms since 1997 and briefly describe their implications for government revenues. Section 7.3 then discusses the methodology that we use to allocate these reforms to households and introduces the useful notion of a ‘tax payment’. To illustrate the practical difficulties that we can encounter when applying this method, we consider the special case of how to allocate the extra payments of stamp duty on residential properties that are due to the introduction of a graduated structure for this tax. Our main results are discussed in Section 7.4, which presents our analysis of the impact on different households of the packages of tax and benefit reforms that Labour has introduced during each of the last two parliaments. Section 7.5 concludes.

7.2 Tax and benefit reforms since 1997

In this section, we add up the overall effect of Labour’s tax and benefit changes on the public finances, and identify some of the taxes and benefits that account for large shares of this total. Information on individual measures helps to give a first impression of the nature of the tax and benefit changes that have affected households. Information on the overall effects of the reforms allows us to see whether Labour has, during each term in office and over the whole period since 1997, used the tax and benefit system to transfer money back to households or to raise money for spending on other purposes.

We consider only changes to taxes, benefits and tax credits. Labour has greatly increased spending on some public services since midway through its first term, with large increases in spending on the NHS and education planned to continue throughout the next spending review period. We do not attempt here to allocate spending on public services to particular households, or to include further details of its revenue effects in the discussion of this section.²

For the measures that we do allocate to households, we estimate what their effects on government revenues and household incomes in 2005–06 are likely to be. This means that in effect we compare the actual 2005–06 tax and benefit system with the tax and benefit system that would have been in place in 2005–06 in the absence of any of the reforms. This comparison tells us what the cumulative effect of Labour’s reforms will be on households in 2005–06. It does not, therefore, measure changes in revenues – and corresponding changes in household incomes – *during* the period. We ignore altogether reforms that had only temporary effects on revenues, such as the windfall tax, the £100 one-off winter payment to over-70s in 2004–05, and the abolition of advance corporation tax. Whether measures were introduced early or late in a parliament is also irrelevant for our analysis, since we do not take account of how many years households have benefited/lost from them.

¹ This updates previous IFS analysis: chapter 9 of R. Chote, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2003*, IFS, London, 2003 (<http://www.ifs.org.uk/budgets/gb2003/ch9.pdf>).

² For a discussion of the amount spent on public services, see section 4 of C. Emmerson, C. Frayne and S. Love, *A Survey of Public Spending in the UK*, Institute for Fiscal Studies, Briefing Note number 43, 2004 (<http://www.ifs.org.uk/bns/bn43.pdf>).

In estimating the revenue effects of various tax and benefit reforms, we have to decide what exactly constitutes a reform. Our estimates are derived from reforms and costings listed in various Budgets and Pre-Budget Reports, and therefore measure changes relative to the assumptions made in the public finance forecasts. These provide for some cash rates and thresholds to increase in line with a range of measures of inflation (with various rounding rules applied) and for others to remain fixed in cash terms. Thus, for example, increasing income tax thresholds in line with inflation would be counted as ‘no change’, but increasing stamp duty thresholds in line with inflation would be counted as a tax cut, since the public finances assume that income tax thresholds rise in line with inflation every year while stamp duty thresholds remain fixed in cash terms.

We follow this practice throughout this chapter, so that we have the same costings for reforms as the government; this also allows us to interpret these costs as (roughly) the change in the fiscal position that would result from reversing them. But public finance assumptions have no special economic status, and in some cases are quite arbitrary. An alternative assumption would be that ‘no change’ meant all cash rates and thresholds remaining unchanged in real terms, i.e. increasing in line with (a single measure of) inflation. A third, more radical, view would be that ‘no change’ meant cash rates and thresholds increasing in line with growth in the tax base: income tax thresholds in line with taxable incomes, corporation tax thresholds in line with taxable profits, stamp duty thresholds in line with the total value of housing transactions in the economy, and so on.

The choice between these assumptions can make a substantial difference to the results. For example, the fact that incomes have risen faster than prices has increased the total number of income tax payers (and the number of higher-rate taxpayers in particular: see Figure 2.15), thereby increasing income tax revenues – the phenomenon of fiscal drag. By assuming, like the government, that ‘no change’ means income tax thresholds rising in line with prices rather than incomes, we do not count this extra revenue as a discretionary tax increase introduced by the government. Another important case is stamp duty, since in recent years house prices have risen much faster than the overall price level and the government assumes that stamp duty thresholds do not even rise in line with the overall price level; we discuss this further in the next section. The Treasury estimates that the fiscal drag implied by the definition of ‘no change in policy’ in the public finances increases government revenues by 0.2% of national income a year.³ This figure highlights the importance of the choice of counterfactual ‘no change’ scenario: relative to the Treasury’s baseline which we adopt, the cumulative effect of fiscal drag from 1997–98 to 2005–06 is an increase in revenues of £20.0 billion in 2005–06, dwarfing the net revenue effects we calculate below. The effect of fiscal drag on tax revenues is discussed further in Chapter 2.

Estimates of the implications of tax and benefit reforms since 1997 for the public finances in 2005–06, made under the conventional Treasury costing assumptions, are reported in Table 7.1. Over the entire period, the net effect of all policy changes to the tax and benefit system is a small fiscal loosening of £1.1 billion (around 0.1% of national income) compared with what the government’s budgetary position would have been had the May 1997 system simply been

³ Paragraph A.24 of HM Treasury, *End of Year Fiscal Report*, December 2003 (http://www.hm-treasury.gov.uk/media/324/70/end_of_year_352%5B1%5D.pdf).

updated in line with the conventional public finance assumptions. This figure is actually the difference between a large set of revenue-raising measures (around £57.2 billion) and a slightly larger set of costly reforms (around £58.3 billion). For example, Table 7.1 shows that costly changes to income tax, such as the introduction of the 10% starting rate and the reduction of the basic rate, have been more than offset by revenue-raising changes to the same tax. By next year, the exchequer will also have gained significant net revenues from changes to National Insurance contributions and indirect taxes (such as road fuel duties), plus a smaller amount from stamp duties. The projected net revenue gains from all the tax changes implemented since 1997 together raise around £18 billion (for more details on how the tax burden has risen since 1997, see Chapter 6). This almost pays for the projected net cost of £18.7 billion of benefit increases and the creation of new credits and tax credits.

The overall fiscal loosening is not evenly split between measures implemented in the 1997–2001 parliament and those implemented during the current parliament. This is perhaps not surprising, given the discrepancies in the amounts raised from tax measures each Budget within and between each parliament (see Table 6.4 in Chapter 6).

Comparing total effects across each parliament, the net effect of measures implemented before 2001 is a giveaway of £4.8 billion next year, but measures implemented during the current parliament are set to raise a net £3.7 billion for the exchequer next year.

Only a small part of this difference is accounted for by the fact that benefits and credits were increased more in the first parliament than in the second: measures implemented between 1997 and 2001 will cost £10.5 billion in 2005–06, while those since 2001 will cost £8.2 billion. The main difference is in the revenues that Labour has raised by reforming certain taxes. The biggest example is National Insurance contributions, where reforms between 1997 and 2001 will cost £2.0 billion in 2005–06 but reforms during the current parliament will raise £8.7 billion. Particularly large sums were raised by the uncapped one percentage point increase in contribution rates for employees, employers and the self-employed announced in Budget 2002 and implemented in April 2003. Corporation tax is another area in which costly reforms were implemented between 1997 and 2001, but from which revenue has been raised since. In contrast to National Insurance contributions, the revenue raised from corporation tax changes since 2001 is outweighed by the cost of the earlier reductions, giving a net cost to the exchequer of £3.3 billion in 2005–06. Not all taxes have been increased by more in the second term than in the first – notably indirect taxes and stamp duties. In 2005–06, £6.4 billion will be raised from indirect tax changes implemented during the first parliament, but very little from changes since 2001. Stamp duty reforms in the first term will raise £2.4 billion in 2005–06, but changes implemented subsequently very little. (Stamp duty on residential properties is discussed in more detail in the final part of Section 7.3.)

In sum, the overall impact on the public finances of reforms to taxes and benefits made since 1997 has been the relatively small difference between a large set of revenue-raising reforms and a slightly larger set of revenue-reducing ones. Since different measures might have quite different impacts on the incomes of specific households, the small overall revenue impact does not necessarily preclude substantial distributional effects. The next two sections analyse how the overall package of reforms has affected different households in the population.

Table 7.1. Revenue effects in 2005–06 of changes to taxes and benefits since 1997

	Revenue raised for exchequer		
	1997–2001	2001–2005	Total
Total income tax	£3.2bn	£0.9bn	£4.1bn
<i>Of which:</i>			
Married couple's allowance	£3.5bn	£0.0bn	£3.5bn
Income tax rates and personal allowances	–£7.3bn	£0.1bn	–£7.2bn
Dividend tax credits	£7.3bn	£0.0bn	£7.3bn
Total National Insurance contributions	–£2.0bn	£8.7bn	£6.7bn
<i>Of which:</i>			
Employee contributions	–£2.0bn	£3.9bn	£1.9bn
Employer contributions	–£1.5bn	£3.9bn	£2.3bn
Total indirect taxes	£6.4bn	£0.1bn	£6.6bn
<i>Of which:</i>			
VAT	–£0.8bn	£0.9bn	£0.1bn
Tobacco taxation	£2.6bn	£0.0bn	£2.6bn
Alcohol taxation	–£0.2bn	–£0.0bn	–£0.2bn
Insurance premium tax	£0.4bn	£0.0bn	£0.4bn
Road fuel duties	£5.3bn	–£0.6bn	£4.7bn
Vehicle excise duty	–£1.1bn	–£0.2bn	–£1.3bn
Total stamp duties	£2.4bn	£0.3bn	£2.7bn
<i>Of which:</i>			
Changes to rates for properties	£2.3bn	£0.0bn	£2.3bn
Total corporation tax	–£4.8bn	£1.5bn	–£3.3bn
<i>Of which:</i>			
Changes to rate structure	–£4.5bn	–£0.5bn	–£5.0bn
Total change in cost of benefits / tax credits	–£10.5bn	–£8.2bn	–£18.7bn
<i>Of which:</i>			
Mortgage interest relief at source	£3.6bn	£0.0bn	£3.6bn
Personal tax credits ^a	–£6.4bn	–£4.1bn	–£10.5bn
Child benefit (and child trust fund and non-attributable child-based reforms)	–£1.8bn	–£0.2bn	–£2.1bn
Pensioners' package (winter allowance, basic state pension and minimum income guarantee increases, pension credit, etc.)	–£5.0bn	–£3.3bn	–£8.3bn
Overall total	–£4.8bn	£3.7bn	–£1.1bn

^a These are working families' tax credit (WFTC), disabled person's tax credit (DPTC), child tax credit (CTC) and working tax credit (WTC).

For further notes, see next page.

Notes to Table 7.1: All costings have been reflatd to 2005–06 prices using nominal GDP growth published by the Office for National Statistics and (for projections) HM Treasury. The totals include all measures, not just the taxes and benefits costed in detail in the table. Some taxes and benefits have been reformed more than once since April 1997, which means that they may score as both exchequer gains and exchequer losses.

The figures in the detailed breakdowns in this table are approximate. In some instances, it is not possible to break down the cost of measures introduced into the categories given in the table. For example, increases to child premiums in both income support and WFTC are often grouped together in costings published by the Treasury. In such cases, the effect of the changes is either attributed to the category deemed likely to be responsible for the greater part of the cost, or added to child benefit (and non-attributable child-based reforms). The difficulty with separating the effects of some measures also explains why WFTC, DPTC, WTC and CTC are considered as one category.

Sources of Table 7.1: HM Treasury, Financial Statement and Budget Report and Pre-Budget Report, various years.

7.3 How do we allocate tax/benefit payments to households?

To analyse how the tax and benefit reforms detailed in Section 7.2 have affected different households, we need to allocate the payment and receipt of these financial transfers to particular households. For some payments, this is relatively straightforward. For example, for benefits and (tax) credits that are paid directly to an individual or family, it is natural to allocate this transfer payment to the household in which the recipient lives. However, for some transfers, and in particular some taxes, it is less obvious to whom we should allocate the payment. The next subsections explain how we apportion different taxes and benefits to particular households, and how these allocations are used to approximate the distributional impact of tax and benefit reforms.

The ‘tax payment’ of a household

The method that we adopt allows us to derive a measure of the distributional impact of a broad range of taxes and benefits. We use the notion of a household’s ‘tax payment’,⁴ which is the sum of the tax levied on all spending by household members and that levied on the incomes received by household members, minus any benefits or tax credits that they receive. Thus:

- Taxes on the expenditures of households, such as VAT, excise duties and stamp duty on house purchases, should be allocated to the household making the purchase.
- Taxes on income from labour supplied, including both employee and employer National Insurance contributions, should be allocated to the worker’s household.
- Taxes on the return to capital, such as income tax on savings and dividends, capital gains tax and corporation tax, should be allocated to the household owning the capital, which has the right to the income stream on which the tax is levied.

In order to be clearer about what this notion of a ‘tax payment’ *is* capturing, it is helpful to consider some of the things that it does *not* measure. Rather than focusing on who has the formal liability for a tax, or who actually makes the payment to the government, economists

⁴ This terminology and many of the ideas here are due to A. Dilnot, J. Kay and M. Keen, ‘Allocating taxes to households: a methodology’, *Oxford Economic Papers*, 1990, vol. 42, pp. 210–30.

often use the notion of ‘effective incidence’ – in other words, who is ultimately made financially worse off as a result of a particular tax being imposed rather than collecting the same revenue (and financing the same pattern of government expenditure) from some other source. The notion of a ‘tax payment’ does not exactly match either formal or effective incidence.

For example, the formal liability for duty on cigarettes lies with the trader who withdraws them from a registered warehouse or factory; and it is firms that are obliged to pay VAT on their sales. Nonetheless, few doubt that increases in cigarette duty or VAT are at least partly passed on to consumers via higher prices, so that the effective incidence of these taxes is at least partly on the consumer, rather than (say) the owner of the firm. But it is hard to be sure just how much of a rise in these taxes would be passed on to consumers. Since it is relatively easy for us to observe the expenditures of individuals, our pragmatic method for allocating the payment of these taxes to households is to attribute the whole payment on a given expenditure to the household containing the individual who spent the money.

Similarly, employee National Insurance contributions (NICs) are formally taken *out of* an employee’s wages, while employer NICs are formally paid by the employer *in addition to* the employee’s wages. But all NICs, regardless of whether they are nominally employer or employee contributions, are levied on a base of wages and salaries. A basic principle of economics is that the effective incidence of a tax should not depend, at least in the long run, on whether it is levied on the buyer or the seller of a good or service. Thus the effective incidence of employer NICs may be on employers, to the extent that it is not shifted onto workers in the form of lower wages. But if this is so, the effective incidence of employee NICs would also fall on employers, as higher wages would then need to be paid to attract the same workforce. There may be disagreement as to whether the effective incidence of NICs is mainly on workers or mainly on the owners of firms, but it is hard to think of any reasonable principle that would result in employer and employee contributions being treated differently when allocating the taxes to households. Given the difficulty of assessing the effective incidence of NICs, our methodology allocates both employee and employer contributions, along with income tax due on labour income, to the household containing the individual on whose earnings the tax is levied.

If one keeps in mind exactly what a ‘tax payment’ is, then this notion can provide a useful first approximation to how a given tax system affects individuals. The next subsection explains how we attempt to calculate these payments for different households in order to make an assessment of the distributional effects of tax reforms.

Assessing the effects of tax reforms

In Section 7.4, we use the IFS tax and benefit micro-simulation model, TAXBEN, to allocate tax payments to households. We simulate what the tax and benefit systems that existed at the times of the 1997 and 2001 elections would have looked like in 2005 if there had been no policy reforms since, i.e. these systems are updated in line with public finance assumptions, as described in the previous section. Our aim is to compare these counterfactual tax and benefit

systems with the ‘actual’ 2005–06 tax and benefit system.⁵ TAXBEN applies these three tax and benefit systems to the same data on incomes, expenditures and demographic characteristics of households at a given point in time in order to calculate the ‘tax payments’ implied by the different systems for each household. Following this procedure involves ignoring any changes in households’ behaviour (quantities purchased, labour supplied, etc.) that might occur because of differences between the tax and benefit systems. Since we ignore behavioural changes in this way, we must be cautious about how literally we interpret our results as measuring the welfare effects of reforms: households’ well-being depends on many factors, including the amount that they consume, the number of hours that they work, and any costs of time, effort or stigma associated with claiming benefits and tax credits.

The combination of such costs of making applications and lack of information means that many people do not claim means-tested benefits and tax credits to which they are entitled. Yet TAXBEN models households’ entitlement to programmes, not their actual receipt. It could be argued that entitlements are a better representation of government intentions than receipts, although it also seems likely that governments take account of likely non-take-up when they calculate what size of means-tested programme they can afford to implement. Whatever the intended effects of programmes, receipts measure the financial gain that households actually experience.

Table 7.1 showed that means-tested benefits and tax credits have become more generous under Labour. It might therefore be expected that, by modelling entitlements rather than receipts – in effect assuming full take-up – we will overestimate the increase in incomes experienced by households lower down the income distribution (by the amount of any unclaimed extra entitlements), and therefore overestimate the progressiveness of Labour’s reforms. In practice, however, the direction and size of any bias are less clear, for three reasons:

- First, we will overestimate the progressiveness of the reforms only in so far as the change in unclaimed entitlements – not just the programmes as a whole – is distributed progressively across the population. It is unclear how progressively distributed the change in unclaimed entitlements might be, since non-claimants are more likely to be those with higher incomes (and thus lower entitlements) and Labour’s reforms have extended means testing higher up the income distribution.
- Second, modelled entitlements do not in fact greatly exceed administrative data on receipts (presumably because errors in the survey data lead us to underestimate entitlements), so we will tend to overestimate the progressiveness of the reforms only in so far as the unclaimed extra entitlements are distributed more progressively than the entitlements we fail to model. This depends on whether entitlements are underestimated for relatively high- or low-income groups, which is hard to ascertain.
- Finally, take-up is not fixed throughout the period: if take-up rates have increased among the poorest, for example, then the increase in their receipts might be larger, not smaller, than the increase in their entitlements, and we will tend to underestimate the

⁵ Many of the rates and thresholds for the 2005–06 tax and benefit system have already been announced. For the remainder, we uprate the 2004–05 system in line with public finance assumptions, as described above.

progressiveness of the reforms. It is unclear, therefore, what the overall impact of ignoring non-take-up is.

Aside from failing to model take-up of benefits and tax credits, there are also a number of measures that we cannot allocate to specific households in the way described above. These are predominantly certain taxes levied on businesses and on non-labour income. As our above comments on ‘taxes on the return to capital’ indicated, these taxes can generally be captured within our notion of a ‘tax payment’. The problem in practice is that patterns of stock ownership through institutions such as unit trusts and pension funds make it very difficult for us to observe from our survey-based data-sets how share ownership and dividend incomes are distributed across the population and therefore whose ‘tax payment’ should include such taxes.

Simply excluding any reforms to these taxes from our assessment of the distributional effects of Labour’s tax and benefit reforms could create a misleading impression. As a crude solution, therefore, we assume that the tax and benefit changes not modelled in TAXBEN have an equal proportionate impact on all households.⁶ In one case, however, we can improve upon this: stamp duty on residential properties. For while we do not have adequate survey data on the distribution of property purchases across the population to model this properly, we do have data on the distribution of property values, which can be used to approximate the distributional effect of changes to stamp duty on residential property. The methodology that is used to do this, and the results of the exercise, are the subject of the next subsection.

Stamp duty on residential property

Although stamp duty on land and buildings is paid on transactions of both residential and non-residential properties, here we consider only sales of residential properties.⁷ We restrict our attention in this way because it is easier to allocate payments across the income distribution when the buyer is an individual or family, rather than a company.

As explained above, we would like to allocate the ‘tax payment’ from stamp duty on housing, as a tax on household expenditure, to the buyers of properties. We cannot allocate payments of stamp duty to particular households using TAXBEN because the data that we use to identify how spending is distributed do not provide sufficient detail on who spends money on house purchases. Using an alternative data-set, however, we can attempt to allocate payments of stamp duty on residential properties. This subsection explains how this can be done and describes the results of the exercise. As we explain below, even with this alternative data-set, we are still only able to give an approximate answer to the question of how spending on house purchases is spread across the income distribution.

⁶ By allocating any difference between the net effects given in Table 7.1 and the net effects modelled in TAXBEN in this way, we also allocate proportionately to income any difference between our estimates and the government’s estimates of the costs of reforms we do model.

⁷ Stamp duty on non-residential properties has been the subject of some reforms that have not been replicated for residential properties. For example, in December 2003 the threshold at which stamp duty starts to apply was increased from £60,000 to £150,000 for non-residential properties only.

Reforms to stamp duty on residential properties since 1997

When Labour came to power in May 1997, stamp duty was due at a rate of 1% on the value of property transactions that exceeded £60,000. Transactions of £60,000 or less were not liable for the tax. Between July 1997 and March 2000, a graduated structure with higher rates was introduced via a series of incremental reforms. This structure has remained unchanged since then, so all of the extra revenues from increases in stamp duty rates were raised by measures introduced during Labour's first term in office. Table 7.2 shows the rates of stamp duty on property that applied at the time of each of the last two general elections, as well as at the present date.

Table 7.2. Rates of stamp duty on property at different points since 1997

Transaction value	Election 1997	Election 2001	January 2005
£0–£60,000	0%	0%	0%
£60,000–£250,000	1%	1%	1%
£250,000–£500,000	1%	3%	3%
Over £500,000	1%	4%	4%

To summarise, the rate of stamp duty on any residential property that sells for more than £250,000 has increased since 1997. It has increased from 1% to 3% for properties that sell for between £250,000 and £500,000, and from 1% to 4% for properties that sell for more than £500,000. The changes were completed a full year before the election of 2001.

Revenues from stamp duty on residential properties have increased rapidly in recent years, from £675 million in 1996–97, to £2.690 billion in 2001–02, to £3.795 billion in 2003–04. This has happened not only because of the introduction of the graduated rate system, but also because of fiscal drag. House prices have risen rapidly, but the stamp duty exemption threshold has been fixed at £60,000 since 1993, well before Labour came to power.⁸ The higher thresholds have also remained fixed since Labour introduced them in 1997. This has meant that many more purchases are liable for stamp duty than in 1997⁹ and more are subject to the higher rates than when they were introduced, substantially increasing the revenue raised by stamp duty.

As discussed in Section 7.2, we do not count the increase in revenue due to the rise in house prices relative to fixed stamp duty thresholds as discretionary tax rises. Instead, we follow the assumption in the public finances that 'no change' in stamp duty thresholds means a freeze in cash terms. While not wrong, this assumption is essentially arbitrary. It would be equally reasonable to assume that 'no change' means the thresholds increasing in line with the rate of retail price inflation in the economy, as is done for many other tax thresholds. Relative to this baseline, the government's actual policy of freezing the stamp duty thresholds represents a cut in the thresholds of around 10% during each parliament since 1997.¹⁰

⁸ The stamp duty exemption threshold for residential properties was increased to £150,000 in designated 'disadvantaged' areas from November 2001.

⁹ For the UK excluding Scotland, in 2003–04 73% of transactions of residential and non-residential property were liable, compared with 49% in 1997–98. Source: Table 16.5 of *Inland Revenue Statistics*.

¹⁰ In fact, using retail price index inflation for the year to the previous September, 10.4% in the 1997–2001 parliament and 8.8% in the current parliament.

Alternatively, it might be argued that a reasonable baseline assumption is that the thresholds increase in line with house prices, which have risen at a much faster rate than overall prices. Relative to that baseline, Labour has cut the stamp duty thresholds more than in half since mid-1997,¹¹ clearly a major tax rise. However, we do not have good estimates of how much lower stamp duty revenue would have been if the thresholds had in fact been increased in line with house price inflation or retail price inflation.¹² For that reason as well as those mentioned in Section 7.2,¹³ we restrict attention to the revenue raised from the introduction of the graduated rate structure; but it should be noted again that other approaches are equally valid.

Labour has not changed the fact that stamp duty operates as an average rate tax. This means that if a property transaction falls into the top stamp duty band, then the tax is paid at 4% on the full value of the sale, not just the value exceeding £500,000. Similarly, if a transaction falls into one of the lower bands, then 1% or 3% tax will be levied on the entire transaction value. To take an example, a £400,000 property transaction will be liable for £12,000 of stamp duty, which is 3% of £400,000.¹⁴

Table 7.3. Yield of stamp duty on residential property, 2003–04

Stamp duty band	Yield, £ million	Proportion due to change in rates	Estimated amount due to change in rates, £ million
£0–£60,000	0	0	0
£60,000–£250,000	1,300	0	0
£250,000–£500,000	1,360	$\frac{2}{3}$	907
Over £500,000	1,130	$\frac{3}{4}$	848
Total	3,795	n/a	1,754

Note: Figures may not sum exactly because of rounding.

Source: Authors' calculations from table T15.3 of *Inland Revenue Statistics* (http://www.inlandrevenue.gov.uk/stats/stamp_duty/table15_3_october04.pdf).

Table 7.1 indicates that £2.3 billion of extra revenue has been raised from the introduction of graduated rates of stamp duty on land and buildings since 1997, but does not isolate how much of this has come from residential properties. We approximate this figure using data published by the Inland Revenue, which give the yield of stamp duty on residential properties

¹¹ In fact, 57%, using the change in the mix-adjusted house price index for the UK from third quarter 1997 to November 2004. Source: Office of the Deputy Prime Minister (http://www.odpm.gov.uk/stellent/groups/odpm_housing/documents/page/odpm_house_023935.xls).

¹² As shown in Appendix D, raising by £5,000 the £250,000 threshold in stamp duty on both residential and non-residential property would cost around £50 million in 2005–06.

¹³ And also because the data that we use do not contain a sufficiently large number of houses valued close to the stamp duty thresholds for us to allocate such tax reliably to specific households, especially for the case in which the default would be to uprate the thresholds with general price inflation.

¹⁴ Economic arguments favour changing the average rate structure. This structure means that a small difference in the purchase price can lead to a large change in tax liability if it moves the transaction across a threshold. This creates unnecessary distortions in the housing market, encouraging house-sellers to charge prices that are just below the tax thresholds, and never to charge prices that are within a few thousand pounds above a threshold. The incentive to hold prices below thresholds in this way could also increase the cost to the tax authorities of monitoring housing transactions in order to ensure that value is not artificially shifted from houses on to separately sold items such as furnishings and contents. It is hard to think of a good reason for encouraging clustering of house prices at certain values.

for each stamp duty band. For 2003–04, the latest year for which figures are published, yields were given as in the first column of Table 7.3.¹⁵

If the structure of stamp duty had not been changed after 1996–97, then for property transactions exceeding £60,000 in value, the tax yield would have been 1% of transaction values. Because of changes in the tax structure, the tax yield for transactions in the £250,000–£500,000 price range in 2003–04 was actually 3% of transaction values. This means that, relative to the system that applied in May 1997, transactions in this price range in 2003–04 incurred extra stamp duty worth 2% (the excess of 3% over 1%) of their value. In other words, two-thirds of the tax yield for these transactions was due to the reforms. By similar reasoning, we can argue that three-quarters of the yield on transactions above £500,000 was due to increases in the tax rate. Applying this method, Table 7.3 shows that we estimate the amount of extra tax paid to be around £1.8 billion.¹⁶ On average across the population, this amounts to around £1.30 per household per week.

The analysis in this chapter is concerned with how tax and benefit reforms implemented since 1997 will affect household incomes in 2005–06, but here we have to use figures on the yield of stamp duty in 2003–04. If the number and price of purchases rise between 2003–04 and 2005–06, then the yield from the higher rates of stamp duty in 2005–06 will be somewhat larger than the figures given in Table 7.3. A corollary of this would be that the amounts raised in 2005–06 from the introduction of a graduated structure will be larger than the amounts listed in the last column of the table. Conversely, if the number and price of purchases fall between 2003–04 and 2005–06, then we will be overestimating the amount raised by these reforms in 2005–06.

The distributional effects of reforms to stamp duty on residential property

We now turn to how the estimated £1.8 billion raised by the introduction of a graduated structure for stamp duty on residential property might be allocated across the income distribution. As mentioned above, we would like to allocate the payment of stamp duty on residential property to the buyer of the home. In order to allocate payments of stamp duty on properties in this way, we would need to know the incomes of house-buyers and the amounts that they paid for their new homes. But data of this kind are not easily available. We can, though, observe the incomes and estimated property values for existing homeowners in the 2002 British Household Panel Survey (BHPS).¹⁷ We allocate the burden of stamp duty across the income distribution according to these data. That we are constrained to use this methodology provides a clear illustration of how data limitations can complicate the task of allocating tax payments to households.

¹⁵ Notice that by using revenue data for 2003–04, we will capture the effect of measures – such as extra policing of avoidance or the exemption of some contracts between registered social landlords and their tenants – which affected the stamp duty base and had come into effect before the end of tax year 2003–04. The revenue effects of such measures are dwarfed by the effects of the reforms to the rate structure of the tax that are our main focus.

¹⁶ Such a methodology will not give quite the right amount since a small proportion of stamp duty revenue (8% across residential and non-residential purchases in 2003–04) comes from duty levied on new leases ('lease duty'). Only part of lease duty is levied at the same rates as duty on property purchases.

¹⁷ University of Essex, Institute for Social and Economic Research, British Household Panel Survey; Waves 1–12, 1991–2003 [computer file]. Colchester, Essex: UK Data Archive [distributor], June 2004. SN: 4967.

To the extent that house-buyers have different characteristics from homeowners, allocating payments of stamp duty according to the values of the stock of properties owned and the characteristics of owners will give us different results from allocating according to the values of properties that are traded and the characteristics of buyers. First-time buyers are perhaps especially likely to fall into different age and income groups from typical homeowners. Also, the approximation will only be accurate to the extent to which homeowners tend to stay within the same stamp duty band when they move home. Nonetheless, our calculations do give us some idea of how payments of stamp duty might, on average, be spread across the population.

Table 7.4 Distribution of the value of homes worth more than £250,000, across the income distribution

Income decile group	Percentage of value of total stock of homes worth £250,000+
Poorest	5.2
2	3.7
3	3.2
4	8.4
5	6.9
6	7.9
7	8.7
8	15.5
9	13.7
Richest	26.8
<i>Total</i>	<i>100.0</i>

Notes: Income decile groups are constructed by ranking households according to their income adjusted for family size and then splitting the population into 10 equally sized groups.

Source: Authors' calculations from the 2002 British Household Panel Survey.

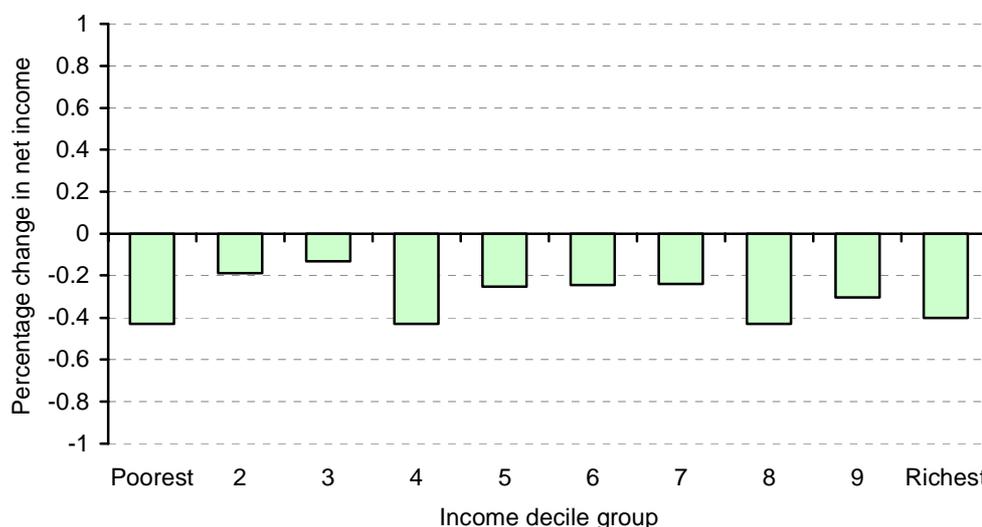
To allocate the payments of extra stamp duty revenues raised by reforms since 1997 across the income distribution, we divide the population into 10 equal-sized groups ('decile groups') according to their income, measured after taxes and benefits and adjusted for household size. Treating each stamp duty band in turn, we then allocate to each group a share of the extra stamp duty raised that corresponds to the group's share of the total value of all properties in the relevant price range. In order to make our calculations as representative as possible of 2005 house prices, we use the average rate of house price growth in the UK between September 2002 and November 2004 to uprate the house prices reported in the 2002 BHPS.¹⁸ For a sample of 4,665 households from the 2002 BHPS, Table 7.4 reports percentages of the value of the stock of all properties (with appropriately uprated prices) worth more than £250,000 that were owned by households in each income decile group. In the table, we do not split properties according to whether or not they are worth more or less than the upper £500,000 stamp-duty threshold because there were too few very valuable homes in the data to

¹⁸ The mix-adjusted house price index for Great Britain rose by approximately 27% over this period. Source: Office of the Deputy Prime Minister (http://www.odpm.gov.uk/stellent/groups/odpm_housing/documents/page/odpm_house_023935.xls).

make such a split interesting.¹⁹ We do, however, use information on whether or not a home falls into the top stamp-duty band when calculating how much extra tax households in each decile would pay.

We have estimated that, in total, the changes to stamp duty that we are considering raised around £1.8 billion for the exchequer in 2005–06, or around £1.30 per household per week on average. Allocating the stamp duty payments in line with the values of homes owned at different points in the income distribution in our sample, we find that approximately £1 billion of the increase would be paid by the highest income 30% of the population. Of this, almost half would be allocated to the highest income tenth. This implies households in the highest income tenth paying extra tax worth approximately £3.80 per week (or 0.4% of their income), on average, as a result of these stamp duty reforms. Figure 7.1 shows the percentage income loss for each tenth of the income distribution due to the introduction of a graduated rate structure for stamp duty on residential properties.

Figure 7.1. Losses across the income distribution from the introduction of a graduated rate structure for stamp duty on residential properties



Note: Income decile groups are derived by dividing all households into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth. Sources: Authors' calculations using wave 12 of the British Household Panel Survey and *Inland Revenue Statistics*.

Not surprisingly, considered in isolation the effect of the reform to stamp duty that we have modelled here is small relative to the overall package of reforms that will be considered in the next section: to see this, notice that the vertical scale of Figure 7.1 is one tenth of the scale used on the charts in the next section. It is also hard to discern any progressive or regressive pattern in the losses, although those towards the top of the income distribution certainly pay more in cash terms.

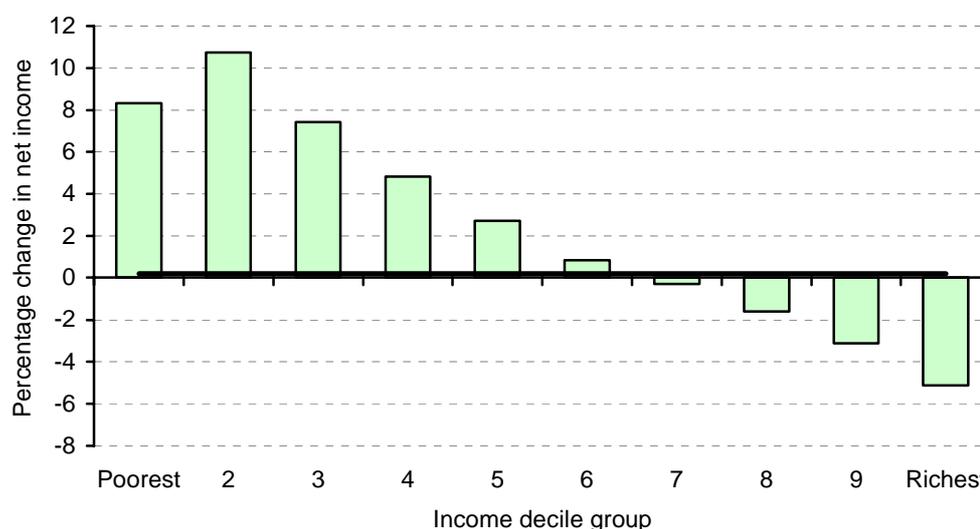
¹⁹ There were 722 households with homes worth more than £250,000, but only 149 of these homes were valued at more than £500,000. None of the first seven decile groups contained more than 10 homes worth more than £500,000, and decile groups 2 and 3 respectively contained two and one such houses.

The main aim of this section has been to discuss and illustrate the principles and practicalities of how we allocate tax payments to different households. The example of stamp duty on residential properties provides both an indication of how data limitations can create practical difficulties in the procedure and a special case of how this allocation can be approximated even when data are lacking. The next section uses the notion of tax payments to allocate to households the whole set of reforms that have been introduced since 1997, and to see what the overall distributional impact of these reforms has been.

7.4 Distributional analysis of fiscal reforms since 1997

In the previous sections, we described and costed Labour’s tax and benefit reforms to date and described how we allocate payments to different households. This section presents the results of this allocation.

Figure 7.2. Gains and losses across the income distribution from fiscal reforms since 1997



Note: Income decile groups are derived by dividing all households into 10 equal-sized groups according to net income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth.

Sources: IFS tax and benefit model, TAXBEN, run using updated data from the 2002–03 Family Resources Survey and the 2001–02 Expenditure and Food Survey; Figure 7.1; Table 7.1.

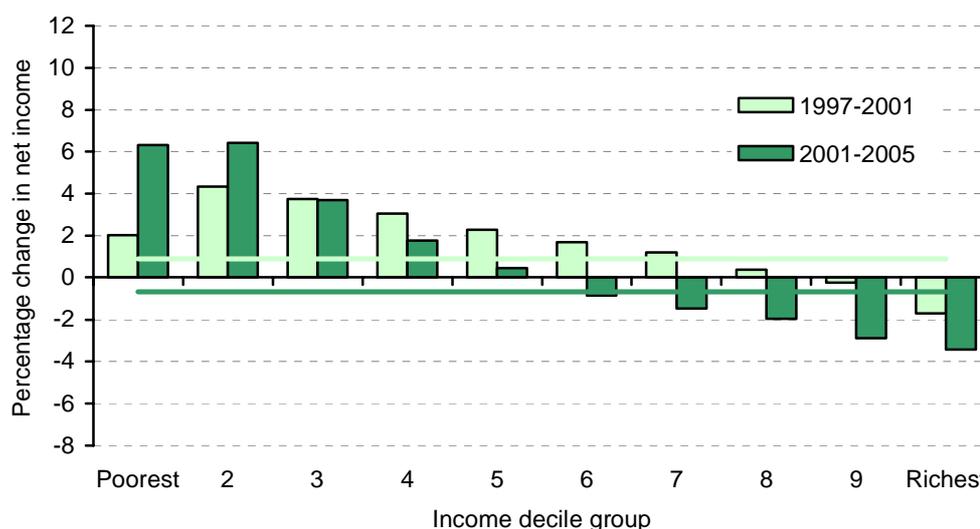
Figure 7.2 shows the estimated effect in 2005–06 of all tax and benefit reforms introduced by central government (i.e. excluding council tax, which is discussed in the next subsection) since 1997 across the income distribution. The £1.1 billion giveaway calculated in Section 7.2 corresponds to an average of £0.84 per household per week, or 0.2% of households’ disposable incomes (the black line in Figure 7.2).²⁰ However, these numbers vary widely

²⁰ The aggregate revenue estimates in Tables 7.1 and 7.3 are for the whole of the UK. Owing to data limitations, throughout the chapter we examine distributional effects for Great Britain only; before allocating unmodelled payments to households, therefore, we scale down the aggregate numbers to reflect the proportion of UK households that are in Great Britain, in effect assuming that the aggregate revenue effect of reforms in Northern Ireland is

across the income distribution, and the overall impact is very progressive. The biggest gains are experienced by the second-poorest tenth of the population, who gain an average of £24.55 per week, or 10.8% of their net incomes; the biggest losses are experienced by the richest tenth, who lose on average £48.57 per week, or 5.1% of their incomes.²¹

Figure 7.3 breaks down the overall changes between the impact of measures implemented in Labour's first and second terms. As we showed in Section 7.2, Labour's first-term reforms entail a net gain to households of £4.8 billion (£3.63 per household per week, on average, or 0.9% of disposable incomes) whereas the second-term reforms entail a net loss to households of £3.7 billion (£2.77 per household per week, or 0.7% of incomes). As a result, most decile groups gain less, or lose more, from Labour's second-term reforms than from its first-term reforms. However, the bottom two decile groups actually gain more from Labour's second-term reforms than from its first-term reforms. Thus, even as the government has been taking money away from households overall, it has been giving money to those on the lowest incomes at an even faster rate than in its first term.

Figure 7.3. Gains and losses across the income distribution from fiscal reforms in the 1997 and 2001 parliaments



Note: See Figure 7.2.

Sources: IFS tax and benefit model, TAXBEN, run using updated data from the 2002–03 Family Resources Survey and the 2001–02 Expenditure and Food Survey; Figure 7.1; Table 7.1.

As well as looking at the effects of Labour's reforms across the income distribution, we can also see how they affected different household types. Table 7.5 shows a pattern of losses on average for childless workers and gains on average for lone parents, non-working families

proportional to that in the rest of the UK. Even if this assumption is inaccurate, the scaling involved is too small to make a substantial difference to the results.

²¹ Households are put into income decile groups according to their net incomes (i.e. after personal taxes and benefits) using the 'actual' April 2005 tax and benefit system. If instead we were to use the updated May 1997 tax and benefit system – putting households into decile groups according to what their net incomes would have been in the absence of Labour's reforms – then the results in this section would look even more progressive. Different methods of allocating households to decile groups also help to explain differences between the results here and those in chapter 9 of R. Chote, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2003*, IFS, London, 2003 (<http://www.ifs.org.uk/budgets/qb2003/ch9.pdf>).

with children and (to a lesser extent) pensioners. This is perhaps unsurprising since it is clear from Table 7.1 that much of what the government has distributed to households has been given through tax credits for families with children and a package of benefits for pensioners. These groups are disproportionately to be found at the lower end of the income distribution, and many of the benefits and tax credits in question have been means-tested. Of the groups of large gainers we have singled out here, pensioners have the least-large gains partly because a relatively large proportion of them have relatively high pre-tax-and-benefit incomes. The combination of means testing and restricting programmes to groups that tend to have low incomes anyway is crucial in explaining the progressive patterns seen in Figures 7.2 and 7.3.

Table 7.5. Gains and losses for different household types from fiscal reforms in the 1997 and 2001 parliaments

Household type	Percentage change in net income		Average change in net weekly income	
	1997–2001	2001–2005	1997–2001	2001–2005
Single, not working	-3.1	0.9	−£4.72	£1.45
Single, working	0.0	-3.6	−£0.07	−£10.87
Lone parent, not working	4.0	10.2	£9.64	£24.76
Lone parent, working	5.1	6.5	£17.11	£21.70
0-earner couple, no children	-2.3	0.7	−£7.40	£2.20
0-earner couple, children	3.8	11.2	£12.53	£36.98
1-earner couple, no children	-1.7	-2.1	−£7.01	−£8.62
1-earner couple, children	1.1	1.2	£5.50	£6.12
2-earner couple, no children	-0.6	-3.5	−£3.46	−£19.92
2-earner couple, children	0.7	-2.3	£4.42	−£14.12
Single pensioner	4.4	5.8	£9.53	£12.56
Couple pensioner	1.7	3.1	£6.19	£11.52
Multi-family household, no children	0.8	-3.3	£4.73	−£18.74
Multi-family household, children	2.0	-1.3	£11.98	−£8.05
Overall	0.9	-0.7	£3.63	−£2.77

Sources: IFS tax and benefit model, TAXBEN, run using updated data from the 2002–03 Family Resources Survey and the 2001–02 Expenditure and Food Survey; Figure 7.1; Table 7.1.

Council tax

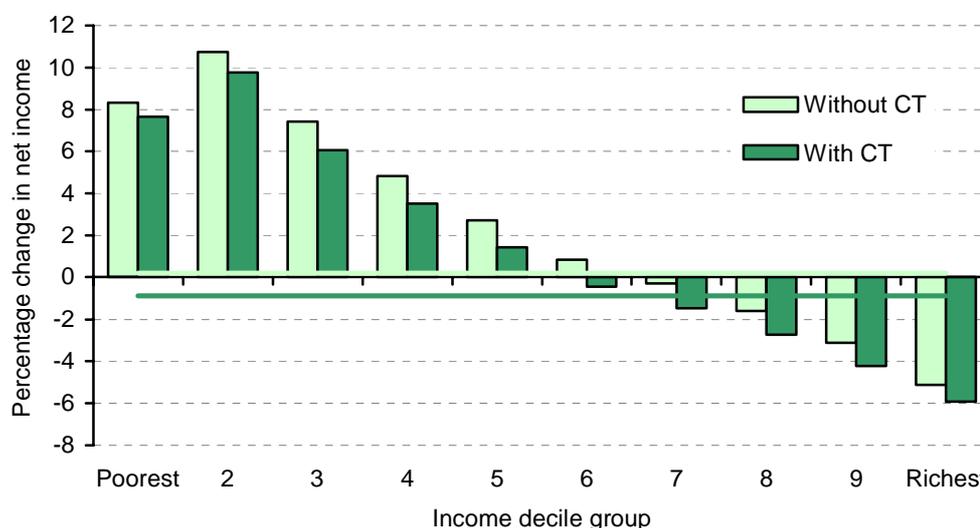
So far, the analysis in this chapter has entirely ignored council tax because the rates are not set directly by central government. But central government grants and demands on local authorities must heavily influence local authorities' decisions, and clearly council tax rises are tax changes that affect households' disposable incomes, so there is a case for including council tax changes in the analysis. In this subsection, we see how doing so affects our results.

Because central government does not set council tax rates, Budgets and Pre-Budget Reports do not give a baseline against which council tax reforms are costed, and there is no obvious assumption to make for what constitutes 'no policy change'. For want of a better one, and in order to accentuate the impact of council tax (since we have already gone to the opposite

extreme by omitting it altogether), we use a baseline of no real change, i.e. all local authorities increasing the council tax rate by inflation.²² Actual rises have been substantially above inflation in both parliaments, with average real increases in England and Wales of around 17% between April 1997 and April 2001 and 18% between April 2001 and April 2004. As noted in Chapter 6, this is the fastest increase of any major tax under Labour, although it remains a relatively small tax in terms of revenue, accounting for an estimated 4.4% of government revenues in 2004–05 (up from 3.9% in 2001–02 and 3.5% in 1997–98).

We estimate that above-inflation increases in council tax since 1997 will raise £5.8 billion in 2005–06, net of any consequential effect on council tax benefit. This corresponds to an average loss to households of £4.46 per week or 1.1% of their disposable income. This is enough to make the average net effect on household incomes of all changes since 1997 negative, since the net giveaway ignoring council tax was estimated to be only £1.1 billion, or £0.84 per household per week on average. The effect of this across the income distribution is shown in Figure 7.4. All decile groups lose from real increases in council tax rates. Apart from the two lowest income decile groups, the percentage loss of income is smaller for each successively higher income group (although the reverse is true in cash terms), reflecting the fact that, on average, council tax rates rise less quickly than income as we move up the income distribution. The bottom two income decile groups are less affected by the inclusion of council tax since many of these households have their council tax bills partly or wholly covered by council tax benefit (remembering that we assume full take-up, as discussed in Section 7.3).

Figure 7.4. Gains and losses across the income distribution from fiscal reforms since 1997, with and without council tax



Note: See Figure 7.2.

Sources: IFS tax and benefit model, TAXBEN, run using updated data from the 2002–03 Family Resources Survey and the 2001–02 Expenditure and Food Survey; Figure 7.1; Table 7.1.

²² More precisely, rising in April in line with the change in the retail prices index for the year to the previous September. We use this baseline both for uprating the April 1997 and April 2001 council tax rates and for assuming 2005–06 rates.

7.5 Conclusion

In this chapter, we have looked at the distributional impact of reforms to taxes and benefits that have been implemented since 1997. The methodological issues that we have examined – defining a counterfactual ‘no change’ scenario, deciding how tax and benefit payments ought to be allocated to individual households, and dealing with insufficient data – mean this is not an easy task and no single answer could be definitive.

Our best estimate is that Labour’s tax and benefit reforms since 1997 imply a net giveaway of £1.1 billion in 2005–06: households gain £0.84 per household per week on average, or 0.2% of their disposable incomes. If real increases in council tax are included, however, the net effect becomes a loss to households of £4.7 billion, equivalent to £3.62 per household per week.

The reforms produce a pattern of losses on average for childless workers and gains on average for lone parents, non-working families with children, and pensioners, and are very progressive overall. However, Labour’s two terms in office have been somewhat different in character.

The government’s first-term reforms will return £4.8 billion to households in 2005–06, whereas its second-term reforms will reduce household incomes by £3.7 billion in total (excluding council tax). But the measures implemented since 2001 are significantly more progressive than those introduced between 1997 and 2001, so despite the government’s reduced generosity overall in its second term, the bottom 20% of the income distribution gain more as a group from Labour’s second-term reforms than from its first-term reforms.