The effect of fiscal tightening on family incomes and child poverty

A new report from the Institute for Fiscal Studies shows that the Coalition Government's Emergency Budget hit families with children hardest. Here, Mike Brewer**,** James Browne **and** Peter Levell **summarise the analysis of who will bear the brunt of the Government's deficit-busting plans.**

June's Emergency Budget was the Coalition Government's opportunity to prove it was serious about cutting the deficit. Not cutting the deficit is not an option: the financial crisis and associated recession opened an additional structural hole of approximately 5.8 per cent of national income, or £86 billion per year in today's terms. Ignoring this would lead to an unsustainable debt path.

But, of course, no political party has ever proposed to do nothing about the deficit. There are choices to be made about how fast to do it, and whether the hole should be filled mostly with tax rises or spending cuts. The previous government suggested filling 70 per cent of this structural hole by 2016/17. The Coalition Government wants to go further faster, closing the hole entirely by 2014/15. In the general election campaign, the Conservative Party suggested that 80 per cent of the hole be filled by cutting spending, and 20 per cent by increasing taxes. This contrasts with the experience of the 1990s, when around half of the hole in the public finances caused by the early 1990s recession was filled by tax rises, and around half by spending cuts. The other parties wanted tax rises to do slightly more of the work and spending cuts slightly less, and, in the end, the path implied by the projections in the Budget assumes that 77 per cent of the work will ultimately be done by spending cuts and 23 per cent by tax rises.

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Most of the decisions about exactly which departments and public services will bear the brunt of these cuts to public spending have been delayed until the Spending Review, which is due to be presented on 20 October. However, the Budget did contain details of £11 billion of cuts to welfare spending that are due to be introduced over the next four years. These include withdrawing tax credits from higher income families, increasing the rate at which tax credits are withdrawn as income rises, cuts in the generosity of housing benefit, reforms to disability living allowance, a three-year freeze in child benefit rates and changes to the way in which in-year changes in income affect tax credit payments. But the biggest change in

terms of the long-run saving to the Government was the decision to link benefits with the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI) or Rossi index (which is the same as the RPI except that it excludes the costs of mortgage interest payments, rent and council tax), as they are at the moment.

The CPI has historically given a lower measure of inflation than either the RPI or the Rossi index, meaning that this change is very likely to save the Government money. There are two main reasons for this. Firstly, like Rossi it excludes the costs of mortgage interest and council tax (although, unlike Rossi, it includes rent), which have, in the past, risen faster than general prices. Secondly, a technical difference in the way the CPI is calculated means that, even if it covered the same goods as the RPI, it would still give a lower measure of inflation.

The Government argues that these differences make it a better measure of the 'inflation experience' of households on benefits – on the grounds that benefit recipients are largely insulated from changes in the housing costs the CPI excludes, and that the way the CPI is calculated allows for the fact that households can minimise the impact of price changes on their welfare by substituting away from goods that have become relatively more expensive.

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The second of these arguments is reasonable, although the first has been questioned by the Institute for Fiscal Studies (IFS). Households that are insulated from housing costs because they qualify for housing benefit and council tax benefit will tend to have their benefits uprated with the Rossi index, which already excludes these things, and not the RPI. For these households, the CPI therefore offers little, if any, improvement in terms of its coverage. For households who do not receive means-tested benefits and, in the main, do pay housing costs, the coverage of the CPI is arguably less appropriate for measuring their 'inflation experience'.

Despite these welfare cuts, however, the Chancellor said that the Budget was a progressive measure. This claim relied on distributional analysis in the Budget, which showed that the richest 10 per cent of households lost more as a percentage of their income than the poorest 10 per cent from the tax and benefit changes that are due to be introduced between now and April 2012. This analysis excludes changes announced in the Budget that are due to come into effect in later years, and changes to housing benefit, disability living allowance and tax credits that are difficult to assign precisely to particular households. In an IFS report published at the end of August, we found that including these measures leads to the reverse being true: the poorest 10 per cent lose more as a percentage of their income from the Budget tax and benefit measures than the richest 10 per cent. And the progressive measures due to come in over the next few years are generally those that were pre-announced by the previous government. If we only look at the measures announced in the Emergency Budget, they are clearly regressive overall – the poorest tenth of households lose more in cash terms, let alone as a proportion of income, than those in the upper middle of the income distribution.

The Shadow Secretary of State for Work and Pensions, Yvette Cooper MP, has used figures compiled by the House of Commons Library to claim that the Budget changes hit women more than men. Performing such an analysis is difficult, because it is hard to know to what extent couples actually share money, but it is certainly the case that the benefits and tax credits being cut are more likely to be received by women in couples than men. The Fawcett Society is now seeking a judicial review of the Budget on the basis that a gender equality assessment of the measures was not undertaken beforehand.

The Chancellor also claimed that the Budget would not increase child poverty, as currently defined by the Government (that is to say, the number of children living in households with less than 60 per cent of median income), over the next two years. This is presumably because of the £210 increase in the child element of child tax credit announced in the Emergency Budget, which benefits the poorest families the most. But the analysis on which this claim was based did not account for the changes to housing benefit, disability living allowance and the reforms to the way in which in-year changes in income affect tax credit payments. Recent IFS analysis has shown that these measures disproportionately affect low-income families with children, so it is probable that the Budget would increase child poverty once these are taken into account.

Even if we accept the Government's claim though, it is important to remember that policy makers will normally have to spend money just to prevent the currently preferred measure of child poverty from rising. This is because benefits are increased only in line with prices, while most people's incomes tend to rise in real terms (that is, by more than prices) each year. As

benefits represent a larger proportion of total income for poorer households, they will tend to fall further behind the median household in the absence of any real increase in benefit spending. This will be even more of an issue in the future as benefits will be linked to the CPI which, as we said earlier, tends to increase less quickly than the indices that were previously used. In the longer term then, it is likely that child poverty will increase unless either more money can be found to increase benefits and tax credits, or the incomes of low-income families with children increase as a result of other changes.

However, the elephant in the room with all this analysis is that it ignores the impact of departmental spending cuts on the welfare of low-income families with children. The Budget figures imply that spending by government departments will be an average of 14 per cent lower by the end of the Parliament. But because the NHS and international development spending are to be spared the pain of cuts, all other departments will have to suffer more, with an average cut of 25 per cent. Furthermore, the Chancellor also suggested that the cuts would be smaller than those for education and defence, which must mean that they will be far larger for those public services that have not been promised such protection.

It is impossible to see how such large cuts can be made without big cuts in the amount that public sector workers are paid, or big cuts in the quality and quantity of public services in their broadest sense. For example, the cuts agreed to by the Department for Education since the election, including scrapping Building Schools for the Future, probably amount to just 2.5 per cent of the education budget.

So the real story of the Budget is that there is much more pain to be unveiled in October's Spending Review. Given the reliance low-income families with children have on public services, it seems likely that they will be among the worst affected by these measures also, although new government policies such as the pupil premium, which gives schools with more pupils eligible for free school meals more resources, may alleviate this somewhat.

It may be possible to reduce the amount by which government departments have to reduce spending further by finding additional savings to the welfare budget. The Government has grand ambitions to reform the welfare system, as witnessed by a discussion document released by the Department for Work and Pensions (DWP) entitled *21st Century Welfare* at the end of July. It identifies the main problems with the current system as being that it is overly complicated and discourages people from working, and sets out ways in which the benefit system could be simplified by combining benefits into a single payment. These ideas seem promising, as they would be simpler for the claimant to understand and navigate, cheaper for the Government to administer (although there would be initial costs involved in setting up a new system) and provide a more seamless transition when families' circumstances change.

But the weak work incentives in the current system identified by the report do not all result from a lack of integration in the system: they result from choices made about the levels of support, levels of disregards, hours rules, and withdrawal rates in the existing benefit and tax credit system. Work incentives could be strengthened with changes to the current set of benefits and tax credits, and without integration of the form set out by the report. However, the report argues that there is a link between the two problems: the complicated nature of the current taxes and benefits may well obscure the size of the financial reward to work, and so changes to financial incentives to work made under the current system may well have less impact than equivalent changes to an integrated benefit system. An integrated system might also lead to better policy making all round, by giving one government department responsibility for all aspects of benefits and tax credits, and by making transparent what can sometimes be opaque and poorly understood interactions between different parts of the benefit and tax credit system.

In the longer term then, it is likely that child poverty will increase

As an example of this, an integrated system could also put an end to the very highest effective tax rates that arise in the current system when people face the withdrawal of several benefits and tax credits at the same time. As the Prime Minister pointed out in his speech to the Conservative Party conference last year, effective tax rates can reach 95.5 per cent for some working lone parents if they are facing simultaneous withdrawal of tax credits, housing benefit and council tax benefit. But reducing effective tax rates for some would increase them for others, bring more people into eligibility for means-tested benefits and increase the overall cost of the system unless benefit rates for those out of work were reduced. The DWP consultation paper acknowledges, and then

ducks, these age-old trade-offs between supporting those on a low income, strengthening work incentives and affordability. It says that 'a balance between incentives and affordability would need to be struck,' that 'reforms will need to consider the balance between contributory benefits and targeting support on those with the lowest incomes,' and that 'at the appropriate stage, we will assess the impact of our proposals on vulnerable groups'. The multi-billion pound question is what the appropriate balance between competing objectives should be, and this is left unanswered. And, as we have said, come the Spending Review this autumn, the Chancellor will be looking to take billions more out of the welfare budget, not to put billions more into it. This means that any promising structural reforms of the type identified in the paper are likely to be accompanied by financial losses for significant numbers of families now in receipt of benefits.

One possible direction of reform that would have a minimal effect on work incentives and not hurt the poorest would be to abolish the universal benefits that currently exist and compensate poorer families by increasing means-tested benefits. Abolishing child benefit and increasing child tax credit to compensate low-income families would save at least £5 billion a year, and a further £1.4 billion could be saved by scrapping the winter fuel payments and free TV licences for pensioners, and increasing pension credit to compensate those with low incomes. Disability benefits, such as disability living allowance and attendance allowance, could be means-tested and carer's allowance could be abolished, with low-income carers able to claim income support instead. This revenue could be used to lower the level of cuts needed in other government departments or to strengthen work incentives for those for whom they are weakest under the current system. The latter of these would tend to increase the incomes of some low-income families with children directly, and might also reduce poverty over a longer period as more parents move into work and increase their earnings.

Therefore, there is still much that is up in the air as far as how the Government plans to close the deficit over this Parliament and how this will affect family incomes and child poverty. The tax and benefit changes announced in the Budget hit low-income families with children particularly hard, and are likely to increase child poverty as currently measured by the Government over the medium term, even if the increase in the child element of the child tax credit means that it will not increase between 2010 and 2012. But as we said at the start, the Government has decided that cuts to departmental spending will do the majority of the work in terms of closing the deficit, and so the details about how these are divided up will be more important in determining how different groups are affected by the necessary fiscal tightening over the next few years. We are also still waiting for more detail on the new Government's strategy for reaching the 2020 child poverty target – this will not be published until March next year. And Frank Field MP is currently conducting a review for the Government into the measurement of child poverty in the future, which might involve examining non-financial measures of social mobility. This may remove the bias towards direct income transfers that has arguably existed in recent anti-poverty policy. We therefore await the Spending Review, together with these additional reports, with keen interest. ■

This article was written before the announcements on child benefit and a universal credit at the Conservative Party conference.

The Distributional Effect of Tax and Benefit Reforms to be Introduced Between June 2010 and April 2014: a revised assessment is available for download from www.ifs.org.uk/bns/bn108.pdf.

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