

Executive Summary

The UK Government announced a number of changes to personal taxation and welfare at the July 2015 Budget. In addition, it announced the introduction of a higher national minimum wage for the over 25s. This briefing note summarises the key reforms and provides an initial assessment of the impact that they will have on households in Scotland. This paper does not provide full details of the impact of changes to individual benefits on Scottish households. It has not been possible to date to disaggregate down to specific groups, although these changes are likely to have negative effects on particular equality groups.

The key points from the analysis are summarised below

- The Budget included significant cuts to benefits and tax credits. These will disproportionately impact low income households. Reforms to tax credits alone will reduce the incomes of between 200,000 and 250,000 households in Scotland.
- Changes to income tax thresholds in the Budget will be of greatest impact to those earning between approximately £45,000 and £100,000. Those earning below £10,600 will see no benefit.
- Overall the measures announced in the Budget are regressive, with households at the bottom of the income distribution incurring the greatest losses in both absolute terms and as a percentage of their income. They can therefore be expected to increase inequality.
- The reforms will also reduce work incentives by increasing the effective tax rate faced by many low income households when moving into employment or increasing the number of hours worked. Some workers will now face an effective tax rate of up to around 90% over a significant income range. This means that would lose up to around 90p in every additional pound received from earnings
- The higher minimum wage for those over 25 will benefit individuals in Scotland earning below £7.20 an hour. However for the majority of households, it will not be sufficient to offset the cuts to benefit income. Because individuals who will benefit from this measure are often part of households with higher-earning individuals, it will not improve the distributional impact of the budget across the household income distribution.

Welfare Reforms

In total, the welfare measures announced by the Chancellor will cut welfare spending by £13 billion a year by 2020-21.¹ The key reforms announced, and the groups most likely to be impacted are summarised in the table below.

Measure	What is the impact?
Freezing all working age benefits and tax credits for four years from 2016/17 to 2019/20	This will reduce the real terms value of the benefits received by most working age recipients. This will affect the claimants of a wide range of benefits in Scotland, including around 577,000 families who currently receive child benefit. Further information on the number of people and households claiming the affected

¹ OBR Economic and Fiscal Outlook, Table 4.20

	benefits are shown in Annex A.
From April 2016, reduction in income thresholds in tax credits and work allowances in Universal Credit (UC)	This will reduce the amount of income an individual can earn before their tax credits start to be withdrawn from £6,420 to £3,850. The equivalents in UC will be reduced to £4,764 for those without housing costs, £2,304 for those with housing costs and removed altogether for non-disabled claimants without children. This reduces incentives to work. Between 200,000 and 250,000 households in Scotland will be affected
Increase the tax credits taper rate from 41% to 48% from April 2016	This increases the speed at which tax credits start to be withdrawn once an individual earns over £3,850. A higher taper means that the rewards for an individual from working more hours, or moving into work, are reduced. Same number of households affected as for reduction in income thresholds.
Restrict eligibility for child tax credit to the first two children, from April 2017.	This will reduce the value of tax credits for future claimants with 3 or more children. There are currently 50,000 households in Scotland with 3+ children receiving tax credits.
From April 2017, those out of work aged 18 to 21 making new claims to Universal Credit will no longer be entitled to the housing element. There are some exemptions.	In Scotland there are currently 2,149 claimants aged between 18-21 on Housing Benefit and JSA with no children. If they were all subject to these new rules, the reduction in housing benefit in Scotland would be around £4.5 million.

These changes will reduce the average incomes of recipients of working age benefits. For example, the Institute for Fiscal Studies (IFS) estimates that the freeze in working age benefits alone will see recipients lose on average £260 a year. Likewise, households affected by the reductions in the income thresholds for tax credits and the work allowance for universal credit are estimated to lose on average £1,000 a year.

In addition, these changes mean that many low income households will now face a very high effective tax rate as the speed with which benefits are withdrawn as people move into work, or increase the number of hours worked has been increased. This can act as a disincentive to work, as much of the additional income will be lost through the withdrawal of welfare payments. The National Institute for Economic and Social Research (NIESR) has stated that:

“Increasing the taper from 41% to 48% increases the effective tax rate faced by families claiming tax credits to 48% for incomes between £3,850 and the NI threshold, to 59% for families paying NI but with annual incomes below £11,000 (£12,500 in 2020/21), and to a whopping 79% for families earning in excess of £11,000 (£12,500 in 2020/21) but still in receipt of in-work tax credits².”

For some households the effective tax rate will be higher still due to the interaction with Housing Benefit and Council Tax Reduction. When these benefits are taken into account households can now face an effective tax rate of up to around 90% over a significant income range. This means that they would lose up to around 90p in every additional pound received from earnings. To put these effective tax rates in context, a higher rate taxpayer not in receipt of benefits currently faces an effective tax rate of just 42%. Someone on an income of £200,000 per year faces an effective tax rate of 47%.

² National Institute of Economic and Social Research (8 July 2015) - Taxes, tax credits and welfare spending

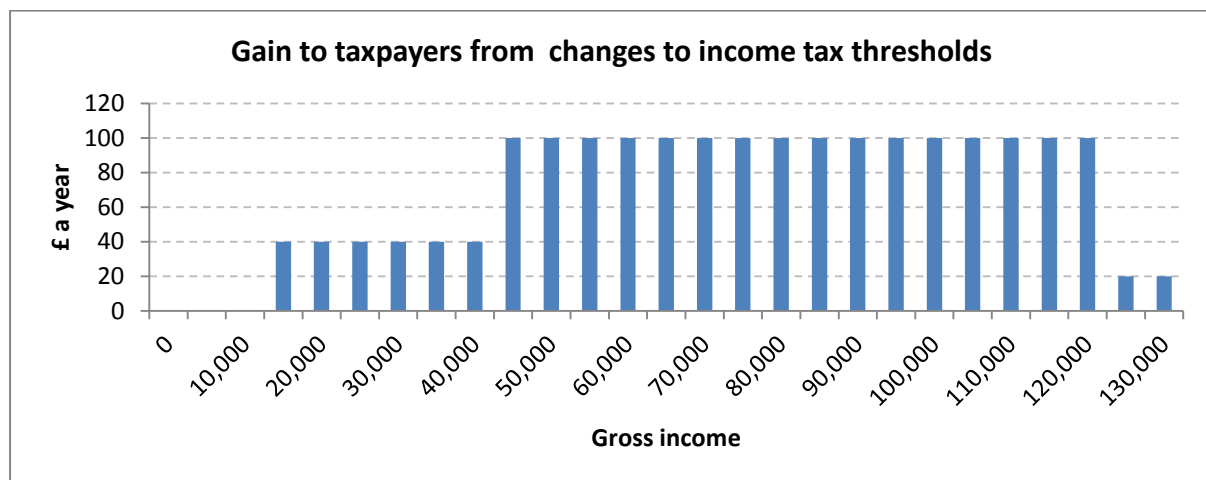
Personal Taxation

The key changes to personal taxation announced by the Chancellor are summarised below.

- Increasing the income tax personal allowance, the point at which someone starts to pay income tax, from £10,600 in 2015-16 to £11,000 in 2016-17.
- Increasing the higher rate threshold, the point at which someone starts to pay the 40% income tax rate, from £42,385 in 2015-16 to £43,000 in 2016-17.
- Increasing the inheritance tax threshold for couples to £1 million from 2020.
- Restricting pension tax relief for those with gross incomes over £150,000 from 2016-17.

Increasing the income tax personal allowance to £11,000 will benefit the vast majority of tax payers in Scotland. For example, someone earning the median Scottish income of £21,100³ would see their income tax bill fall by £40 a year as a result of this measure. However, the increase will be of no benefit to individuals who currently earn less than £10,600 as they are already under the threshold for paying income tax. For such individuals an increase in the point at which they start to pay employee national insurance (currently £8,060) would have been of greater benefit.

The second income tax change, increasing the higher rate threshold, only benefits individuals earning over £42,385 – equivalent to approximately 15% of Scottish income tax payers.



Other significant tax measures in the budget, increasing the inheritance tax threshold and restrictions on pension tax relief, are likely to impact on only a very small number of relatively well-off households.

The inheritance tax reforms represent a tax cut worth almost £1 billion a year by 2020-21 across the UK. The reforms are expected to reduce the number of estates, across the UK, forecast to be liable to the tax in 2020-21 by 26,000. Internal Treasury analysis of the inheritance tax reforms reported in the media suggested that such a policy would *“likely most benefit high income and wealthier households, with some evidence from the ONS suggesting those already living in the wealthiest fifth*

³ Based on 2012-13 data, see: <https://www.gov.uk/government/statistics/income-and-tax-by-county-and-region-2010-to-2011>

*of households are most likely to receive an inheritance*⁴. This policy is also expected to have a relatively smaller impact in Scotland due to lower average property prices. For example, at present just 1,000 estates in Scotland are subject to inheritance tax, 6% of the UK total.

To pay for the reforms to inheritance tax, pension tax relief will be tapered away for those with an adjusted income of more than £150,000 from April 2016, so that reaches a minimum of £10,000 as opposed to the current £40,000 annual limit. This is estimated to raise around £1.3 billion for the Exchequer by 2020-21. HMRC expects around 300,000 pension savers across the UK, or around 1% of taxpayers to be affected by this measure, of which around 17,000 are estimated to be Scottish taxpayers.

Changes to the Minimum Wage

The Chancellor has announced the introduction of a higher national minimum wage for the over 25s from April 2016. It will initially be set at £7.20 an hour, and is expected to increase to £9 an hour by 2020.

It is important to note that although the Chancellor has referred to this measure as a 'National Living Wage', it is not the same as the voluntary living wage currently operated by the Living Wage Foundation. This is currently set at £7.85 an hour outside of London and is calculated with reference to the basic cost of living in the UK. It is therefore set at the level required for an individual to have a minimum acceptable standard of living.

In addition, when calculating the need for a living wage of £7.85 an hour, the Living Wage Foundation already takes into account the income an individual will receive through the welfare tax credit system. The cuts to tax credits and other benefits announced in the budget would therefore further increase the living wage required to achieve the minimum acceptable standard of living.

There are approximately 214,000 workers in Scotland over the age of 25 who currently earn less than £7.20 an hour.⁵ Those people on the minimum wage who live with higher earners will benefit most from increases in the minimum wage as they are outside of the tax credit system. Because minimum wage earners are found right across the income distribution in Scotland, it means that the largest benefits of increases to the minimum wage accrue to higher income households.

Net Impact of Welfare, Personal Taxation and Minimum Wage Changes

This section analyses the net impact of the reforms outlined above to welfare, personal taxation and the increase in the minimum wage. The net effect that these measures will have on a household, will vary considerably depending on a household's composition and current level of income.

As an illustrative example, the Resolution Foundation has estimated the impact of the introduction of a higher minimum wage, alongside changes to tax credits, housing benefit and income tax thresholds on a number of different household types. The results are summarised in the bullets

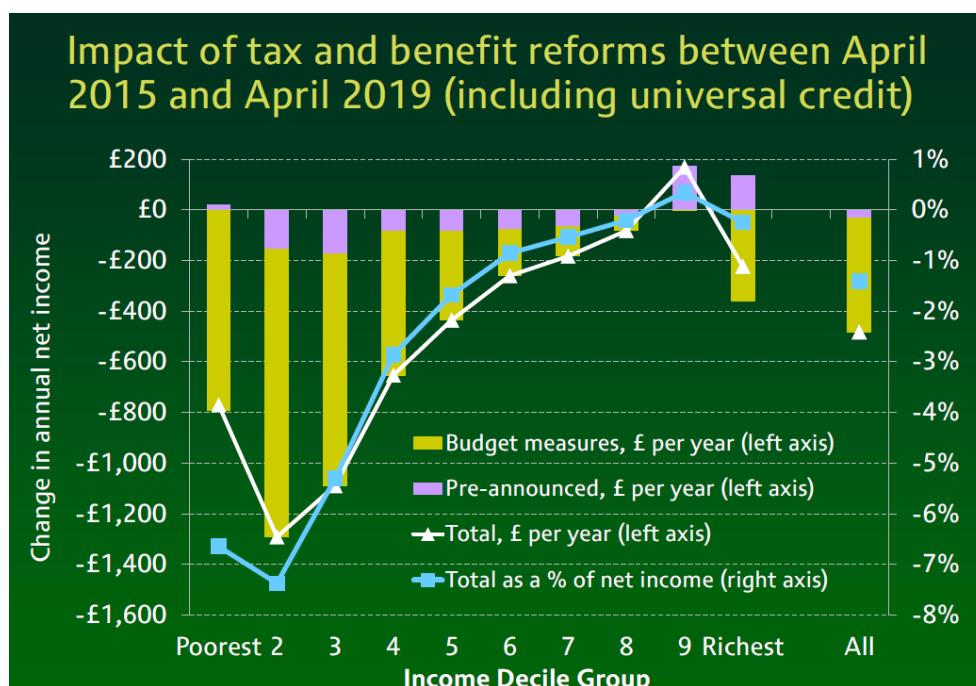
⁴ Guardian (17 March 2015) - Tories' £1m inheritance tax break aimed at wealthier households

⁵ Source: Annual Survey of Hours and Earnings 2014

below, and suggest that many low income households will be significantly worse off as a result of the reforms announced⁶.

- A low earning single parent with one child, working 20 hours a week at £9.35 an hour, will be £1,000 a year worse off. That is, the gain associated with the increase in the personal tax allowance is more than offset by reductions in benefit entitlement.
- A low earning dual-earner couple with two children both earning £9.35 an hour will be £850 a year worse off.
- A middle earning dual-earner couple without children where both earn £15 an hour will be £350 better off as a result of increases in personal tax allowance.

Likewise, the IFS has analysed the impact of the overall package of tax and welfare measures announced at the Budget (i.e. excluding the minimum wage increase). Their analysis shows that the reforms are clearly regressive, with households at the bottom of the income distribution incurring significant losses, as summarised in the chart below.



Source – IFS Post Budget Analysis – Benefit changes and distributional analysis

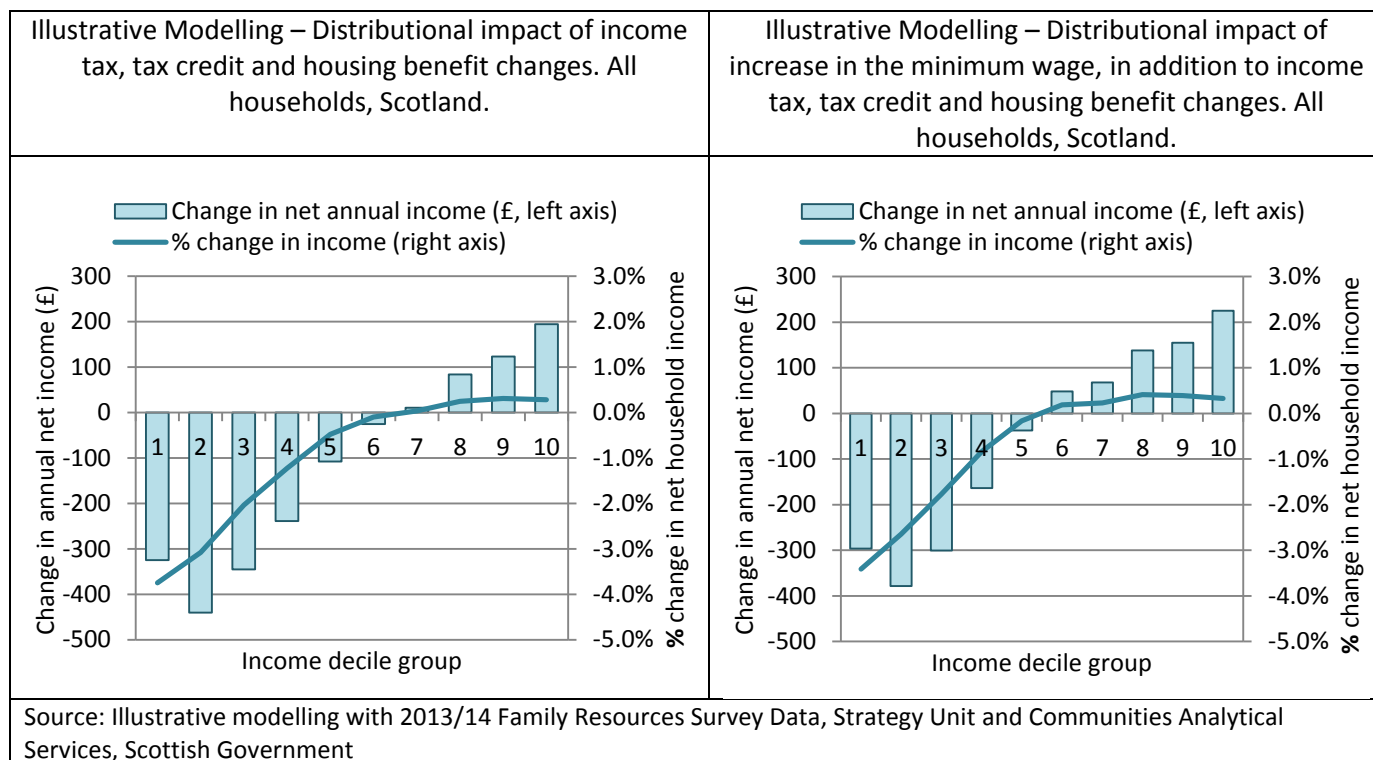
A key question when looking at the impact of the Budget on household incomes is the extent to which the increase in the minimum wage compensates workers for the loss of support via the welfare system. In aggregate, the increase in income from the introduction of a higher minimum wage is not sufficient to compensate for the reduction in welfare income. Assuming no behavioural change, the OBR estimates that the higher minimum wage will increase hourly earnings by £4 billion in total by 2020⁷. However, by the same year the changes to the benefit system announced by the UK Government will have cut welfare payments by between £12-£13 billion in total⁸.

⁶ Resolution Foundation - Welcome boost on low pay but severe welfare cuts will mean big losses for many low-income working families

⁷ OBR – Economic and Fiscal Outlook, July 2015, Pg 202

⁸ HM Treasury – Budget 2015, Pg 74

To illustrate the impact of the higher minimum wage, the charts below present initial Scottish Government modelling by Strategy Unit and Communities Analytical Services of the effect the Budget will have on Scottish households. The chart on the left illustrates the distributional impact of a subset of the tax and benefit reforms announced. It is important to note that this excludes both some benefit cuts, such as the four year freeze to working age benefits, and some of the tax rises such as reduction in pension annual allowance for top earners. The overall results therefore differ from the IFS chart above. However, the relative impact of the Budget, with households at the bottom of the income distribution seeing the greatest losses remains clear. Further information on the modelling is provided in Annex B



The chart on the right then estimates the impact that the higher minimum wage will have on these results. As indicated by the chart, it is estimated that this policy will not fundamentally change the distributional impact of the budget, with households in the bottom half of the income distribution still seeing the greatest proportionate losses. This reflects the fact that many individuals on relatively low hourly wages live with people on higher incomes. There is therefore not a direct link between an individual being on a relatively low hourly income, and the household as a whole having a low income.

Annex A

Number of claimants of benefits set to be frozen for four years from 2015 in Scotland	
Benefit	Number of claimants
Jobseekers' Allowance ¹	77,700
Employment and Support Allowance (excluding claimants in the Support Group) ¹	112,140
Income Support ¹	69,270
Housing Benefit ^{2*} (total)	468,053
Of which :Local Housing Allowance	81,890
	Number of families
Child Benefit ³	576,675
Child tax credit and working tax credit ⁴	352,000
Sources: DWP tabulation tool, DWP StatXplore, HMRC Child Benefit Statistics Geographical Analysis August 2014, HMRC Child and Working Tax Credits statistics finalised annual awards 2013-14 - geographical analysis	
Notes: Total number of households cannot be derived from this table due to double counting. i.e. some of the people who lose from the freeze to housing benefit will also lose from the freezing of child benefit.	
Data relates to different time periods:	
¹ November 2014	
² February 2015	
³ August 2014	
⁴ 2013-14	
* For housing the "applicable amount" has been frozen. This relates to how housing benefit is tapered as incomes rise.	

List of benefits to be frozen from HMRC Summer Budget overview paper [https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/443285/HMRC Summer Budget Overview Version 4 0.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/443285/HMRC_Summer_Budget_Overview_Version_4_0.pdf) (paragraph 2.115, page 4)

Annex B – Illustrative modelling – Technical Notes

The model has been developed by Scottish Government analysts and is based on 2013/14 Family Resources Survey data. The analysis assumes full take up of means-tested benefits and tax credits and it does not incorporate the impact of any behavioural response or secondary impacts (e.g. a reduction in employment due to increased minimum wage). In terms of income tax, tax credits and housing benefit, the illustrative modelling incorporates the following changes:

- Income tax:
 - Income tax personal allowance increased to £11,000 (from £10,600)
 - Higher rate threshold increased to £43,000 (from £42,385)
- Tax credits:
 - Removal of family element in tax credits (currently £545 per annum)
 - Child element of tax credits limited to a maximum of two children (currently no maximum)
 - Reduction of the tax credit income threshold to £3,850 per annum (from £6,420 per annum)
 - Increase in the tax credit taper rate from 41% to 48%
- Housing benefit:
 - Removal of housing benefit support for those under 22 without children and out of work
 - Removal of the family premium for housing benefit (currently over £900 a year)

The removal of the family element in tax credits, the limiting of the child element of tax credits to a maximum of two children and the changes to housing benefit have been applied in full to existing benefit claimants in the illustrative modelling. In practice these will not apply to households that have been in receipt of the benefits with an interruption of less than six months.

The impact of increasing the minimum wage to £7.20 for all workers aged 25 and over has been modelled in addition to the income tax, tax credits and housing benefit changes.

The following changes have not been included in the analysis: freeze to working age benefits; changes to inheritance tax; reduction in pension annual allowance for top earners (those with income over £150,000). The freeze to working age benefits would lead to additional negative impacts on households in the bottom half of the income distribution. The changes to inheritance tax and pension annual allowance are likely to only affect households near the top of the income distribution. While the incorporation of the elements to the model would have an impact on the average change in income, they would not alter the fundamental picture of which deciles gain and which lose as a result of the changes.