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Dear Tim,

The Chancellor has asked me to send you, in advance of his talk with the Prime Minister, a short note on the distributional effects of the main changes in his Budget affecting people's incomes. This is enclosed, along with two tables showing the main figures on alternative bases. The first of these takes no account of rising prices and earnings; the second does.

Yours

John

A.J. WIGGINS

DISTRIBUTIONAL IMPLICATIONS OF THE BUDGET

This note examines the distributional implications of the Budget.

2. The main features affecting personal incomes are the increases in the indirect taxes on tobacco, alcohol and petrol etc; the absence of any increase this year in the income tax personal allowances and thresholds; and the 50p increase from November in the child benefit. These changes come on top of higher employee national insurance contributions which, though announced in November and not part of the Budget, take effect from 6 April.

3. The effects of the Budget can be analysed in simple static terms, ignoring increases in income and prices, or in dynamic terms which take these into account.

Static comparisons

4. This is the simplest approach and looks at the effects of the Budget on families in straightforward cash terms. It takes no account of inflation or of pay increases. The figures simply show how real disposable income goes up or down as a result of the Budget for any given level of gross earnings for 1981/82, all other factors ignored.

5. Table 1 shows the position on this basis. It ignores the increased national insurance contributions as not part of the Budget. The main points which emerge are as follows:-

- (i) Everyone's income is effectively reduced by the Budget measures. There are no cuts in income tax, but the increases in indirect taxes effectively put up prices by 2%.

(ii) The indirect tax increases are not spread evenly. Allowing for patterns of family expenditure, the effects are likely to be broadly proportional to income for single people.

(iii) For married couples the increases will hit those with lower incomes proportionately harder than those with higher incomes. This is the usual regressive effect from putting up the excise duties. Concentrating the increases particularly on petrol helps to dampen these effects but cannot do so completely.

(iv) Families with children do rather better than those without children because of the 50p increase in child benefit from November, fully in line with inflation. It is particularly helpful to families on low incomes, where it covers a larger proportion of the family budget.

6. No doubt comparisons will be made with the position as it would have been if the personal allowances and thresholds could have been increased this year in line with the statutory formula. This would have produced increases of around 15%. On that basis, a single person on average earnings would have had his income tax cut next year by £1.21p a week, an increase in net income of 1.2%. The cut in income tax for married couples would have been £1.90p, or 1.8%.

Dynamic comparisons

7. These try to take account of the effects of inflation in increasing the real burden of income tax, whilst reducing the real burden of the excise duties. The simplest approach is to look at families whose money incomes in the past year have gone up exactly in line with prices, so that they have the same real income as they did a year ago. Table 2 shows some figures calculated on this basis. They rest on the illustrative assumption that gross earnings have risen by 15.1%, the statutory formula for indexing the personal allowances. They are not the only basis for this kind of comparison, but they illustrate the broad effects.

8. On this approach, taxpayers at all income levels are seen to face an even bigger reduction in real net income. This is because, with a progressive tax system, the absence of any increase in the personal allowances and rate bands shows up as a real increase in income tax, and a cut in real take-home pay. This is the effect of fiscal drag. Although cuts are spread across the income scale, they are proportionately largest at the highest incomes. This is because the points at which the higher rates of tax apply are not being increased in line with inflation. Although the child benefit increase helps families with children, their relative position is less favourable on this basis of comparison.

Publicity

9. In past years, it has been usual to issue a press notice on Budget day illustrating the effects of income tax changes on people's net take-home pay. The tables have been issued on both the two bases described above. Since there are no income tax changes to show this year, the tables are unnecessary. No press notice will be issued.

TABLE 1

"STATIC" COMPARISON

Multiple of Average Earnings	2/3	1	1½	3	5
Earnings £ per week	100	150	225	450	750

SINGLE ADULT

Net Income before Budget (£ per week)	71.18	102.80	154.29	277.56	403.28
Indirect Tax (£ per week)	-1.35	-1.98	-2.97	-5.49	-8.01
<u>Net Income after Budget</u> (£ per week)	69.83	100.82	151.32	272.07	395.27
% Change	-1.9%	-1.9%	-1.9%	-2.0%	-2.0%

MARRIED COUPLE

Net Income before Budget (£ per week)	75.63	107.25	158.74	284.97	412.17
Indirect tax (£ per week)	-2.05	-2.35	-2.84	-4.06	-5.28
<u>Net Income after Budget</u> (£ per week)	73.58	104.90	155.90	280.91	406.89
% Change	-2.7%	-2.2%	-1.8%	-1.4%	-1.3%

MARRIED COUPLE WITH
2 CHILDREN

Net Income before Budget (£ per week)	84.18	115.80	167.29	293.52	420.72
Child Benefit (£ per week) ¹	+1.32	+1.32	+1.32	+1.32	+1.32
Indirect Tax (£ per week)	-1.86	-2.17	-2.65	-3.90	-5.16
<u>Net Income after Budget</u> (£ per week)	83.64	114.95	165.96	290.94	416.88
% Change	-0.6%	-0.7%	-0.8%	-0.9%	-0.9%

¹ The November increase in Child Benefit of 50 pence is averaged over the year.

TABLE 2

"DYNAMIC COMPARISON

Multiples of Average Earnings	2/3	1	1½	3	5
Earnings £ per week	100	150	225	450	750

SINGLE ADULT

Net income 1980-81 revalorised ⁽¹⁾ (£ per week)	72.28	104.00	153.80	285.50	418.90
Income tax change ie no revalorisation (£ per week)	-1.21	-1.21	-1.21	-10.10	-18.39
Indirect tax change (£ per week)	-0.64	-0.94	-1.41	-2.58	-3.79
<u>Net Income after Budget</u> (£ per week)	70.53	101.86	151.19	272.82	396.72
% Change	-2.6%	-2.1%	-1.7%	-4.4%	-5.3%

MARRIED COUPLE

Net income 1980-81 revalorised ⁽¹⁾ (£ per week)	77.49	109.11	158.91	294.02	429.12
Income tax change ie no revalorisation (£ per week)	-1.91	-1.91	-1.91	-11.25	-19.77
Indirect tax change (£ per week)	-1.02	-1.15	-1.34	-1.84	-2.34
<u>Net income after Budget</u> (£ per week)	74.56	106.05	155.66	280.93	407.01
% Change	-3.8%	-2.8%	-2.2%	-4.8%	-5.2%

MARRIED COUPLE, 2 CHILDREN

Net income 1980-81, revalorised ⁽¹⁾ (£ per week)	87.33	118.95	168.75	303.86	438.96
Income tax change ie no revalorisation (£ per week)	-1.91	-1.91	-1.91	-11.25	-19.77
Child Benefit change (£ per week)	+0.03	+0.03	+0.03	+0.03	+0.03
Indirect tax change (£ per week)	-0.92	-1.07	-1.31	-1.91	-2.52
<u>Net Income after Budget</u> (£ per week)	84.53	116.00	165.56	290.73	416.70
% Change	-3.2%	-2.5%	-1.9%	-4.3%	-5.1%

(1) ie with full 15.1 revalorisation of allowances & thresholds (and Child Benefit)