The 1987 Budget in Perspective

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I. INTRODUCTION

The run-up to the 1987 Budget saw an even greater amount of speculation as to the form of the Chancellor's proposals than is usual. A large number of suggestions were made as to the appropriate use of the substantial funds available. Most of these were ignored, and the Budget presented on 17 March was in some ways rather a dull event. The principal change to personal direct taxation took the same form as in 1986, a cut in the basic rate, although this was supplemented in 1987 by reductions in the real levels of indirect taxation. There were some innovations, of which the tax subsidies to profit-related pay and the introduction of an over-80s age allowance have perhaps received most publicity, but none of these have major short-term revenue consequences.

In Section II of this article we look in some detail at the distributional impact of the principal changes to personal taxation announced in the Budget. We also consider briefly the rationale for the age allowance, and any increases in its level. In Section III we move on to examine the likely impact of the tax changes on incentives to work, concentrating on married women, the group most likely to respond. Finally, in Section IV we look at the development of the tax system as a whole since 1978/79, using both the IFS tax and benefit model and a technique for describing the overall tax system as a single straight line.

II. THE 1987 BUDGET

1. The Main Measures

As noted above, the main personal tax changes in the 1987 Budget were

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relatively straightforward. All of the main personal allowances were indexed in line with inflation, the basic rate of income tax was reduced from 29 per cent to 27 per cent, and none of the main indirect specific duties were increased at all, thus reducing the real level of indirect tax. Perhaps surprisingly, only the first of the thresholds at which higher rate tax is payable was increased in line with inflation, from £17,200 to £17,900. The second threshold was increased by only £200, and the remainder were left unchanged. Compared with an indexed Budget, this ensures that there are the same number of higher rate payers overall (because the starting point for higher rate tax was indexed), but that they pay more tax and on average face a higher marginal tax rate, since the subsequent higher rate bands have narrowed in real terms. The Chancellor employed a similar device last year. Its rationale is not immediately clear, but it could be that Mr Lawson is trying to compensate for the fact that it is higher rate taxpayers who gain most from cuts in the basic rate, since they are the only people who have the maximum amount of income taxed at the basic rate. The Chancellor's action stands in striking contrast to the pre-Budget speculation about sweeping higher rate cuts.

2. Distributional Consequences

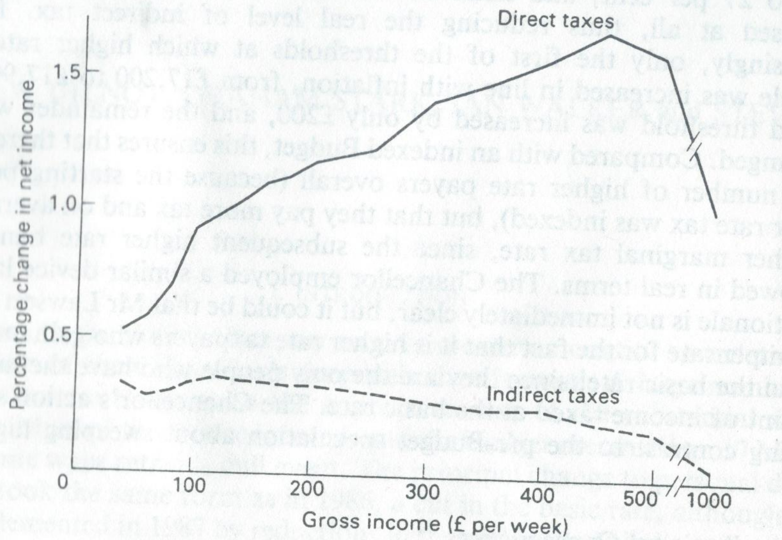
The poorest groups in society gain nothing from the direct tax changes announced in the Budget, as non-taxpayers do not benefit from direct tax cuts. (These groups may, however, benefit from the changes to the levels of indirect taxation.) The next round of benefit upratings, due in April, had already been announced and there were no benefit increases in the Budget itself. The value of most benefits will rise in line with inflation, the main exceptions being means-tested housing benefit, where there is to be an increase in withdrawal rates, and the system of maternity benefits, which is to be recast as part of the 'Fowler' benefit system reforms.

Figure 1 shows the percentage change in net income arising from the Budget compared with an indexed Budget, by ranges of gross income. This change is broken down to show how much is attributable to direct tax changes and how much to indirect tax changes.

Considering first the effects of the direct tax changes, we see that the percentage gain in net income resulting from the basic rate cut rises steadily with gross income, and reaches a peak for those tax units with gross incomes between £400 and £500 per week (who will generally be those at or above the top end of the basic rate band). We would then expect this percentage gain to decline gradually with income (as a given cash gain becomes a diminishing proportion of income), but in fact the decline shown in Figure 1 is more severe than would follow a simple cut in the basic rate. This is because of the under-indexation of the thresholds at which tax at 45 per cent and above begins to be paid.

In contrast to this, the gains from the reduction in the real value of excise

FIGURE 1
Percentage Gains in Net Income as a Result of 1987 Budget Measures compared with an Indexed Budget



duties are more evenly spread. This is because the poor tend to devote a larger proportion of their expenditure to the consumption of excisable goods, in particular alcohol and tobacco, than do the rich (see, for example, Department of Employment, 1986, Table 7).

One rather small change made in the Budget deserves some attention. The Chancellor, while increasing the main age allowances in line with inflation, introduced a new age allowance for the over-80s, to be £110 per annum higher than the basic age allowance for a single person (at £3070 compared with £2960) and £170 higher for a couple (at £4845 compared with £4675). It should, however, be noted that even now the number of over-80s living in the UK is rather small.

The age allowance is a rather complex part of our tax system, with at best a questionable rationale (see Morris (1981) for a full discussion). The basic state pension for a pensioner couple is £63.25 per week, the ordinary personal allowance for a couple £72.98 per week. Thus a pensioner couple with less than £9.73 per week of taxable income would pay no income tax even if the age allowance were abolished. Not only do the pensioners on the lowest incomes not gain, those on the highest incomes receive no benefit from the age allowance. For taxable incomes over £213.85 per week, the excess of the age allowance over the basic allowance is tapered away.[1]

[1] Consider, for example, a pensioner couple with combined income of £215 per week. The income limit for a full age allowance is £188.46 per week. Because the couple have income above this limit, their personal allowance is reduced by two-thirds of the excess, subject to the condition that they must receive at least the ordinary personal allowance. Deducting £17.69 from the couple's age allowance of £89.90

FIGURE 2
Gains from Age Allowance: couple pensioners

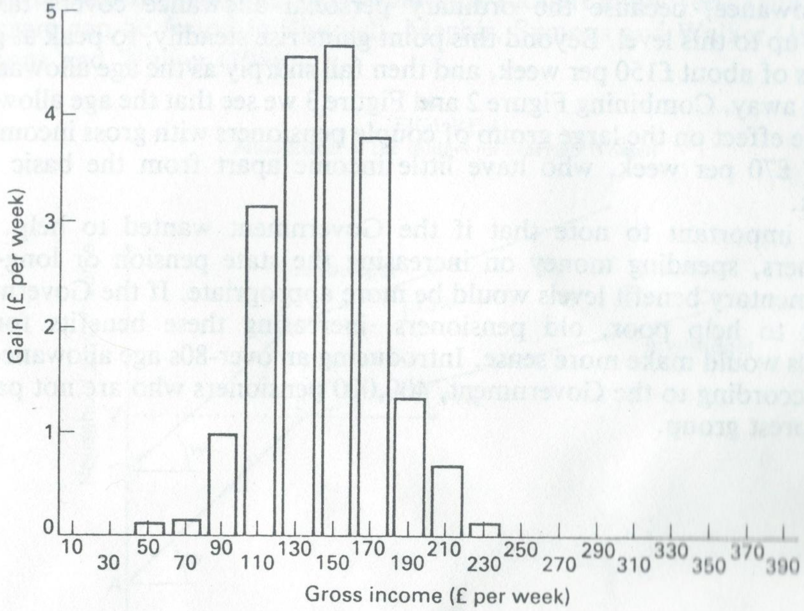
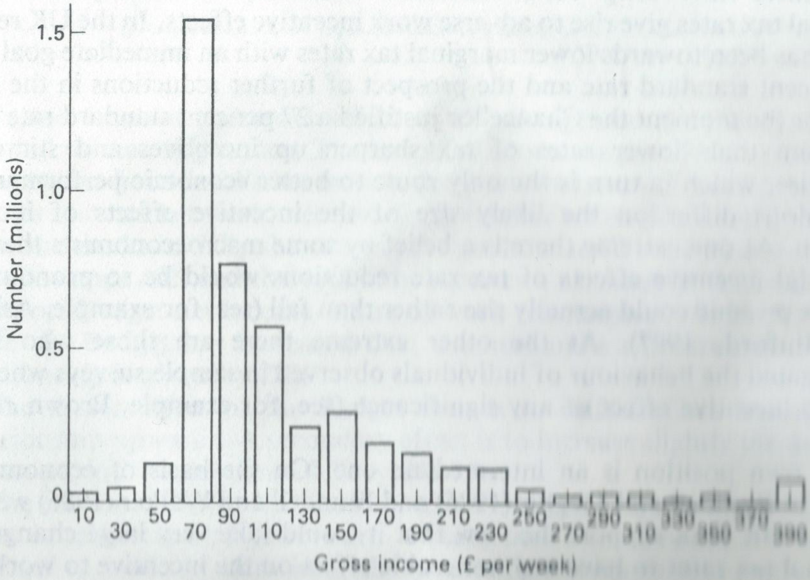


FIGURE 3
Distribution of Income for Couple Pensioners



would leave them with a personal allowance of £72.21 — less in fact than the ordinary personal allowance. The couple thus receive an ordinary personal allowance with no additional allowance for their age.

Figure 2 illustrates these points. We see that for couple pensioners with gross incomes of up to £70 per week there are no significant gains from the age allowance, because the ordinary personal allowance covers taxable income up to this level. Beyond this point gains rise steadily, to peak at gross incomes of about £150 per week, and then fall sharply as the age allowance is tapered away. Combining Figure 2 and Figure 3 we see that the age allowance has little effect on the large group of couple pensioners with gross incomes of around £70 per week, who have little income apart from the basic state pension.

It is important to note that if the Government wanted to help poor pensioners, spending money on increasing the state pension or long-term supplementary benefit levels would be more appropriate. If the Government wanted to help poor, old pensioners, increasing these benefits for the over-80s would make more sense. Introducing an over-80s age allowance will help, according to the Government, 400,000 pensioners who are not part of the poorest group.

III. WORK INCENTIVE EFFECTS

Economists have long been concerned about the possibility that high marginal tax rates give rise to adverse work incentive effects. In the UK recent policy has been towards lower marginal tax rates with an immediate goal of a 25 per cent standard rate and the prospect of further reductions in the long run. For the moment the Chancellor justified a 27 per cent standard rate with the claim that 'lower rates of tax sharpen up incentives and stimulate enterprise, which in turn is the only route to better economic performance'.

Opinions differ on the likely size of the incentive effects of income taxation. At one extreme there is a belief by some macroeconomists that the beneficial incentive effects of tax rate reductions would be so pronounced that tax revenue could actually rise rather than fall (see, for example, Ashton and Minford, 1987). At the other extreme there are those who have investigated the behaviour of individuals observed in sample surveys who can find *no* incentive effect of any significance (see, for example, Brown *et al.*, 1987).

Our own position is an intermediate one. On the basis of econometric results in Blundell and Meghir (1986) and Blundell and Walker (1986) we feel that the UK data support the view that it would take very large changes in marginal tax rates to have any noticeable effect on the incentive to work for prime age married men. However, the estimates do suggest a much greater sensitivity of married women to changes in the structure of incentives. Thus,

here we use an extended version of the IFS tax/benefit policy simulation program to predict what would happen to work incentives for a sample of married women of working age whose husbands are employees. Details of the program can be found in Blundell, Meghir, Symons and Walker (1987) and Symons and Walker (1986).

FIGURE 4

Main Effect of the Budget on Married Women

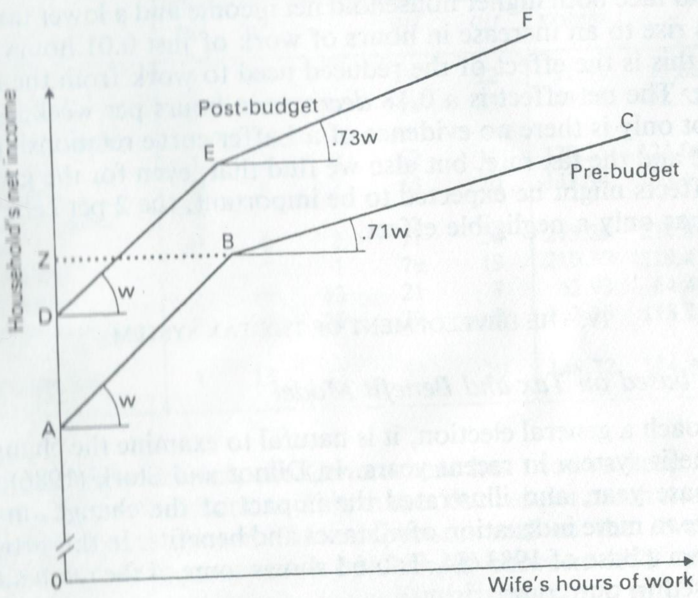


Figure 4 shows the main effect of the Budget on the situation that a married woman might face. The line ABC shows the pre-Budget relationship between her household's net income and her own hours of work per week. If she does no market work, net household income is OA (in pounds); for every hour she works initially she receives £w per hour until her earnings equal her tax allowance AZ, and thereafter she receives a net wage of $0.71w$ per hour. The post-Budget net income/hours of work relationship will be *above* ABC since the Budget has increased OA, the husband's net earnings. The new relationship is given by DEF.

The major effect of the Budget then is to shift the net income/hours relationship upwards. A secondary effect is to increase slightly the new wage of tax-paying women from $0.71w$ to $0.73w$.

The economic theory that lies behind the analysis of the incentive effects of taxes is relatively straightforward. It says that an individual will be *more inclined* to work an extra hour the greater the return to that extra hour of work; and that the greater an individual's income the less that individual *needs* to work. The first effect is a proposition about the effects of a change in the wage rate at a given level of income, while the second is the effect of an income change at a given wage rate.

To get a feel for these separate effects we split our sample into three groups. Non-participants remain non-participants since the additional income makes them less likely to need to work. Non-taxpayers are likely to *reduce* their work effort by virtue of the increase in household net income. Our prediction is 0.2 hours per week. It is only taxpayers (35 per cent of the sample) who face both higher household net income and a lower tax rate. The latter gives rise to an increase in hours of work of just 0.01 hours per week. Offsetting this is the effect of the reduced need to work from the additional net income. The net effect is a 0.18 *decrease* in hours per week.

Thus, not only is there no evidence of a Laffer curve relationship between tax revenue and the tax rate, but also we find that, even for the group where incentive effects might be expected to be important, the 2 per cent cut in the basic rate has only a negligible effect.

IV. THE DEVELOPMENT OF THE TAX SYSTEM

1. Analysis based on Tax and Benefit Model

As we approach a general election, it is natural to examine the changes in the tax and benefit system in recent years. In Dilnot and Stark (1986), we took 1979 as a base year, and illustrated the impact of the changes made since then, relative to mere indexation of all taxes and benefits. In this article we do the same from a base of 1983/84. Table 1 shows some of the main allowances and rates used in our comparison.

The results shown in Table 2 should be treated with more caution than those from our previous exercise. Since 1983 there have been comparatively few discretionary changes to the benefit system (with the exception of

TABLE 1

Principal Rates and Allowances used in the Simulation

		£ *per week*
	Indexed 1983/84	*1987/88*
Single allowance	41.45	46.63
Married man's allowance	64.90	72.98
Supplementary benefit:		
married rate, long-term	63.13	61.85
single rate, long-term	39.47	38.65
Family income supplement:		
prescribed amount, 1 child	99.58	100.70
addition per child under 11	10.86	11.90

TABLE 2

Changes in Net Income under Current Tax and Benefit System compared with Indexed 1983 System

	Percentage of household group:					Net income (£ per week)		
	>5% worse off	*1-5% worse off*	*<1% change*	*1-5% better off*	*>5% better off*	*Indexed 1983 system*	*Current system*	*Average change* (£ per week)
Single	2	23	7	46	22	91.93	95.66	+3.73
Lone parent	0	11	10	46	33	87.76	92.52	+4.76
Single-earner couple:								
childless	3	22	8	52	15	120.35	124.06	+3.71
with children	0	8	7	65	20	148.94	155.13	+6.19
Two-earner couple:								
childless	0	1	2	77	20	215.89	224.89	+9.00
with children	0	1	1	79	19	210.89	219.43	+8.54
Single pensioner	1	38	33	21	7	63.93	64.48	+0.55
Couple pensioner	3	39	26	27	5	112.26	113.25	+0.99
Whole population	1	15	12	52	20	148.72	154.27	+5.55

housing benefit). Instead, the Government has tried to keep benefits rising broadly in line with inflation. This makes our results much more sensitive to the precise period chosen for comparison and to the level of inflation assumed. For the comparisons of changes between 1979 and 1986, such considerations were relatively insignificant compared with the large real changes involved. We have used the tax and benefit system as it was in Spring 1983 (i.e. before the 1983 election but after the 1983 Budget), uprated by 20.7 per cent, the increase in the retail prices index between January 1983 and January 1987.

Almost three-quarters of households experience an increase in net income over the period, with the main gains going to two-earner couples and to families with children, whilst the main groups with significant losses are pensioners, single people, and some childless couples. These gains and losses are due to a combination of tax changes, both direct and indirect, and also to changes in benefits. The most important of these are outlined below.

Direct taxes have fallen substantially over the period as the basic rate of income tax has been cut from 30 to 27 per cent and the real value of personal allowances has risen. These changes have led to widespread and substantial gains, mainly amongst those in work. The overall level of indirect taxation has risen over the period, with reductions in the duties on petrol, wine and spirits being more than offset by increases in the duties on beer and cigarettes. However, these indirect tax changes only reduce the gain of the average household by about 20 pence per week. The proportionate loss will, though, tend to be greater amongst poorer households where excisable goods generally form a larger part of total consumption than in richer households.

Benefit changes over the period have in general favoured families with children, with increases in the real level of family income supplement, child benefit and one parent benefit. Those dependent on supplementary benefit have, however, seen small falls in the real value of their entitlement, whilst means-tested housing benefit has also been cut back, leading to some large losses, especially amongst pensioners.

2. Analysis based on 'Linearisation' of the Tax System

Thus far, we have been considering the results of recent Budgets by examining the impact on a representative sample of households. We now turn to analysis using a framework which we have developed extensively (see Dilnot, Kay and Morris, 1983, and Kay, 1985) for describing the overall tax system as a single linear function of a tax credit and a single marginal tax rate. Thus, if the tax schedule is a tax credit of £1000 and a marginal rate of 60 per cent, tax for an individual with income of £10,000 would be (10,000 × .60) – 1000, or £5000. The schedule covers all taxes: direct, such as income tax and National Insurance contributions; indirect, such as VAT and alcohol taxation; and intermediate, such as business rates and derv duties. In Table 3 we present results for four types of family, in 1978/79, 1983/84 and 1987/88, all in 1987/88 prices.

Between 1978/79 and 1983/84 the tax burden increased for almost all families. All four experienced higher overall marginal rates, as the higher VAT and National Insurance contributions more than offset reduced rates of ncome tax, and all but the single-earner couple with two children suffered a eduction in the real level of the tax credit. Much of this increased burden can e traced to the 1981 Budget, which increased direct and indirect taxes. Since

TABLE 3

The Tax System as a Whole

1987/88 prices

	1978/79		1983/84		1987/88	
	Tax credit	*Marginal rate*	*Tax credit*	*Marginal rate*	*Tax credit*	*Marginal rate*
ingle person	611	59.3	514	62.7	499	60.0
ingle-earner couple + 2 children	1025	50.7	1160	53.2	1231	50.9
ingle-earner childless couple	1003	59.5	948	63.0	930	60.3
wo-earner childless couple	1413	58.3	1075	61.1	1093	58.3

1983/84, taxes have generally come down, as suggested by the analysis above. All groups have experienced a reduction in the marginal rate of between 2 and 3 percentage points; two of the four have higher tax credits, two lower but only slightly lower. The main effect of the 1987 Budget was to reduce the marginal rate through the cuts in the basic rate of income tax, although the burden of indirect tax also fell slightly. In all four cases, the overall marginal rate is now not far above its 1978/79 level, having fallen from its 1983/84 high, but tax credits are still lower for all except the family with children: such families have been hit less hard by increases in indirect tax rates. One more Budget like that of 1987, if the money were carefully distributed, could genuinely leave the overall tax system for these groups on a par with 1978/79.

V. CONCLUSION

The principal tax change in the 1987 Budget was a reduction in the basic rate of income tax from 29 per cent to 27 per cent. This change produces gains which increase as income rises. The income tax change was supplemented by cuts in the real rates of indirect taxation, thus helping those who pay no income tax and who do not gain from the basic rate reduction. The great bulk of the population has gained from the tax and benefit changes introduced since 1983, although losses are concentrated amongst the poorer groups. However, it is still the case that the tax burden for much of the population is greater than it was in 1978/79.

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