good work
how to cut taxes for low earners

Jonty Olliff-Cooper

Progressive Conservatism Project

DEMOS

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Jonty Olliff-Cooper
June 2010

Executive summary

Raising the point at which people in work start to pay Income Tax is a central plank of the Liberal-Conservative coalition government's agenda. Not only is it part of the glue that binds the coalition government together, taking poor workers out of tax is also popular with the public: at least 58 per cent of people agree with this as an aspiration for government.[1]

But the Coalition's proposals are not coherent. They cut tax for low earners, but keep national insurance contributions, which start at an even lower level of earnings at present. And by setting an arbitrary round figure, they only postpone the continued erosion of the tax-free personal allowance.

Instead of simply raising the Income Tax threshold to £10,000, this report argues that a much more progressive and conservative approach would be to link the point at which workers start to pay both tax and national insurance to a democratically determined figure, one that represents what we as a society think is the bare minimum needed to participate in society.

The report not only presents a fully costed roadmap for reform, but also demonstrates how cutting tax at the bottom, rather than at the top, can cut welfare dependency, improve child development, strengthen families, boost local economies and enable people to participate in the Big Society that is so central to progressive Conservatism. Now cutting the burden of taxation on the poorest in work is a central aim of the new government, *the key question is not if we should raise the personal allowance, but how and by how much*.

Recommendation

The report recommends raising both the Income Tax and national insurance threshold to £10,361, equivalent to the Joseph

Rowntree Foundation's minimum income standard for a single person without children after tax credits. Although this looks like a minor difference of only £361 more than the Coalition's pledge, in fact, by abolishing national insurance on low-earners, our measure would provide an *83 per cent greater benefit to someone working full time on the minimum wage than the Liberal Democrat's pre-election proposals, and 127 per cent greater than what the Coalition has so far done* in the June 2010 Budget.

Of course, the minimum income standard is different for every demographic, so an ideal system would link the threshold for every worker to their individual minimum, but since our present tax administration cannot handle such a tailored approach, linking the direct tax and national insurance threshold to the minimum income standard for a single individual without children is the best practical baseline. The report outlines how the cost can be mitigated by adjusting the bands and rates of either the higher or basic rates of taxation to soften the fiscal impact on public finances.

Benefits

Lifting the combined Income Tax and national insurance-free allowance

- ensure everyone in work can meet the minimum needed to participate in society
- cut tax for everyone in work earning over the new allowance by £777 and national insurance contributions by £451 – leaving workers £1,128 better off
- encourage people into work by allowing workers to keep 31.7 pence more for every pound they earn from the current tax allowance up to the new threshold
- foster self-reliance on personal earnings rather than handouts from the state
- demonstrate the strongest possible connection between hard work and fair reward

Impact

Raising the threshold would cut the number of working families below the minimum income standard by 29.4 per cent and the number of single working adults under the minimum income standard by 39.6 per cent.[2] For those in the 'twilight zone' between the breadline and the minimum income standard, it would cut the number of working adults by 47.4 per cent and the number of working families by 35.8 per cent. Such a reform would also shift equal numbers to within a few percentage points of the minimum income standard. Proportionally, for households composed of a single adult with no children, raising the threshold would in fact provide the biggest benefits to single person households earning £13,000–16,000 a year. In shared households of two people without children, couples with combined earnings of £20,418 to £25,255 would benefit most and higher figures for households with children. In addition, cutting both national insurance and Income Tax would have knock-on benefits on the incidence of poverty. The number of working lone parent families in poverty would be cut by a third.

Funding reform

The full cost of this measure is £31.8 billion. This paper does not discuss where tax rises or savings should be made to compensate for this. However, the cost could be cut by more than a third by adjusting the tax bands, without creating any losers. The paper discusses two options for doing this. One involves changing the higher rate of tax, which would reduce the cost to £26 billion. The second involves changing the basic rate of tax, and would cut the cost down to £20 billion – and of course further economies could be made elsewhere to reduce the burden on the Exchequer.

Although this may seem an enormous amount, it should be set against the existing £40 billion cost of the current level of tax-free personal allowances; more if national insurance allowances are taken into account too. This report does not argue for the creation of national insurance or tax-free thresholds ex nihilo. It merely argues that if there is to be a tax-free threshold at all, it should be in a sensible place, democratically agreed and based on real human needs. Indeed, cutting tax at the bottom is only returning the threshold nearer to its historic levels. Figures are not available for national insurance; for tax, relative to national income per head, the allowance has almost halved since the 1970s.

The foundation stone of liberal conservatism

David Cameron has spoken of removing the couple penalty as a signal of social values. This reform signals a still more fundamental principle: self-reliance. It is time to reassert freedom, fairness and responsibility not just in rhetoric but loud and clear within the tax system, in every pay packet.

Moreover, without a basic level of income, citizens struggle to participate in both the liberal and Conservative visions of the good life. The very definition of the minimum income standard is the minimum needed to play a part in society. Without social interaction, children struggle to access activities that build the character and soft skills essential to become autonomous, self-sufficient, responsible citizens. Cut off from the mainstream, couples' relationships are put under excessive strain and communities are unable to strengthen themselves. Put simply, with millions below the minimum income standard, the big ideas of progressive Conservatism will struggle to work in practice. How can we build the Big Society when millions lack the basic income to participate in it?

So rather than seeing this measure as a grudging concession to the Liberal Democrats as the price of government, Conservatives should embrace this measure as a compelling symbol of the new government's radicalism and an essential adjunct to, and bedrock for, the progressive Conservative vision of a more stable, responsible, capable, united and participatory society, economy and democracy.

Key facts from the report

- The minimum income standard is defined as one that includes, but is more than just, the minimum income required to provide food, clothes and shelter. It is about having what you need in order to have the opportunities and choices necessary to participate in society.[3]

- Judged by the minimum income standard, new research for Demos indicates that there are at least 14 million children and working age adults living below the minimum income standard[4] – 58 per cent more than the current government definition of poverty covers – despite the fact that 3.77 million of those are working (or children of people working).[5]
- Single people working full time cannot meet the minimum income standard on the minimum wage. They would need to earn £7.09 an hour after tax, national insurance, housing costs and benefits to reach this weekly standard, but the minimum wage is only £5.80.
- Wages have to be much higher for those supporting a family, even taking account of benefits. A single-earner couple with children would need to earn well over double the national minimum wage to reach the minimum standard.
- The situation is even more acute for younger workers supporting themselves who need to work as much as 75 hours a week to meet the minimum income standard on the national minimum wage.[6]
- At the moment millions of people on low wages are pushed below a minimum standard of living by taxation, causing them to be dependent on government tax credits to get by. Even someone on the minimum wage has nearly £1,000 taken in Income Tax.[7]
- The poorest people in society pay the highest proportion of their earnings as tax. The poorest quintile pays 39 per cent of its earnings as direct and indirect tax (which includes national insurance); the richest pays 34 per cent.[8]
- Someone on median earnings used to pay 17 per cent of their earnings in Income Tax and national insurance in 2000. They now pay 24 per cent. Workers earning approximately the minimum wage full time paid 10 per cent of their earnings as Income Tax and national insurance in 2000. They now pay 15 per cent.[9] Someone on £14,000 has seen an equivalent increase in the size of their Income Tax and national insurance burden as someone on £200,000. Those who have been spared most are mid-level earners.

- Relative to national income per head, personal tax allowances have almost halved since the early 1970s from 45 per cent to 26 per cent of gross GDP per capita.[10]
- A single person earning £10,200 a year pays £1,300 a year tax and national insurance, and falls short of the minimum income standard by a similar amount, despite getting over £1,300 in tax credits. So any government assistance is cancelled out by tax. In the range £10,400 to £13,800, this person is being taxed into falling below the minimum income standard.
- A single person needs £11,489 a year net in order to afford the household budget calculated by the minimum income standard research. But at present, such a person needs to earn £13,859 a year before tax to achieve this net figure because they pay £1,477 and £894 in tax and national insurance respectively. Someone earning this much pre-tax is not eligible for tax credits.
- If Income Tax and national insurance contributions were abolished below £10,361, a single working aged adult without children earning that figure would earn the minimum income standard of £11,48, boosted the final £1,128 by working tax credit.[11]
- Altering the threshold makes it almost £2,500 easier for a single earner with no children to reach the minimum income standard. Under this scenario, a single person on the national minimum wage would have enough to meet minimum income standard. If they were paid year-round for 37½ hour weeks (the standard assumption used by people converting a minimum wage into a full-time annual salary), they would earn £11,341 at the present minimum wage of £5.80, short of the minimum wage by just 1.56 per cent.[12] Tax credits would comfortably take this person over the minimum income standard.
- Raising the threshold would take 700,000 adults and 580,000 children over minimum income standard for their demographic. The measure would lead to a 29.4 per cent drop in the number of working families below the minimum income standard and a 39.6 per cent drop in the number of single working adults under the minimum income standard.[13]
- This equates to a 47.4 per cent decrease in the number of single working adults and a 35.8 per cent drop in the number of

working families in the 'twilight zone' between the breadline and the minimum income standard. In addition, cutting tax would cut the number of working lone parent families in poverty by 33 per cent.[14]

- For single person households without children, raising the threshold provides the biggest benefits to those earning £13,000–16,000 a year.
- Between current tax allowance and £10,361 this measure makes taking work 31 pence more attractive for every pound earned.[15]
- The full unmitigated cost of implementing these proposals is £31.8 billion. This compares with the cost of £17 billion for implementing the Liberal Democrat proposal and approximately £40 billion for the cost of funding the current personal allowance of £6,475 (compared with if there was no personal allowance at all). However, adjustments to the higher rate of tax or basic rate of tax can leave no taxpayer worse off and cut the cost of the reform by up to a third to £26 billion or £20 billion respectively.
- According to the Institute for Fiscal Studies, the Liberal Democrat policy of raising the Income Tax threshold provided the strongest incentive to work of any manifesto at the 2010 general election.[16]
- The recommendation made here keeps £1,288 in the pockets of anyone earning more than £10,361 – 83 per cent more than the Liberal Democrat proposal, which allows workers to keep only £705 more than at present.

Introduction

In 1843 Benjamin Disraeli described a country of:

Two nations; between whom there is no intercourse and no sympathy; who are as ignorant of each other's habits, thoughts, and feelings, as if they were dwellers in different zones, or inhabitants of different planets; who… are fed by a different food, are ordered by different manners… the rich and the poor.[17]

Today his description rings as true as ever. It is a sign that we live as two nations that nearly 15 million people do not have the income required to participate fully in society. Reversing this deprivation is crucial to repairing our brittle communities, but also key to the development of the stable, self-sufficient individuals, on whom the Conservative vision of society depends.

Certainly, it takes more than income to escape entrenched deprivation and isolation. Assets, networks, cultural capital, capabilities and character are just as important. This report complements recent work by Demos and others which has asserted the importance of education, benefit reform, early interventions, building aspiration, capabilities and cultural capital.[18] However, it is vital to remember that income is the bedrock, the enabler and adjunct to the development of many of these financial and non-financial capabilities. Therefore a properly thought-through strategy for increasing low incomes is an essential part of mending the 'broken society'.

For progressive Conservatives self-reliance, paying your own way and hard work should be the route out of poverty. Paid work was a core element of the Labour government's social inclusion strategy.[19] The fundamental assumption of official Treasury policy has been that paid work is the 'single most effective means of avoiding poverty, both now and in the future'.[20] But at the moment, work is not working. A fifth of all children under the minimum income standard are in working households.[21]

There is much talk from the new government on the need for welfare reform. It is well understood that our current welfare system does not create strong enough incentives to get off benefits and into work.[22] However, what receives much less publicity is that for those who enter work, the state still claws back so much income in tax that many people still cannot reach a minimum standard of living despite working full time. This is an unhelpful penalty on those who heed the rhetoric of politicians, make the right choice and – as Norman Tebbit put it – 'get on their bike and look for work'.[23]

Government is not so interested in this demographic, perhaps because people who are in work, even those in jobs that do not provide enough income to reach the minimum income standard, do not carry the same fiscal cost to the Treasury as those out of work and totally dependent on benefits. However, it is wrong that millions of people on very low wages are being dragged into tax. The measure of need used in this paper is the minimum income standard, defined as the minimum amount to allow a person to participate in society. This paper does not assert that it is a right to receive the minimum income standard, but rather that it is wrong to be taxed before you have even earned this amount yourself.

This report provides a single, powerful, progressive and naturally Conservative policy that can start to be implemented with minimal administrative risk immediately. It tallies with the stated aims of the coalition – to take the poorest workers out of tax – but goes further to redefine the way in which we view Income Tax. It asserts the need for a less arbitrary, or in-flow related, measure of where tax begins to affect people so that our taxation system explicitly takes account of how much of their earnings people need to keep in order to live fulfilled lives. The coalition's policy ambitions are to be lauded, and the raising of the Income Tax threshold vital, but their case would be better made (and their new level for the threshold better justified) if it were premised on the minimum income standard rather than on a nicely rounded but unfounded figure of £10,000. Fundamentally, this report makes the case that – through its overbearing taxation – the state is presently part of the problem as well as part of the solution.[24]

1 Enough to survive, not enough to live: the problem of living below the minimum income standard

This report proceeds from a straightforward question: what is the right level at which to start paying tax?

At present, all workers are entitled to earn £6,475 free of Income Tax and £5,720 free of national insurance contributions per year.[25] However, these are largely arbitrary figures. There is no underlying rationale for choosing £6,475 over, say, £6,000 or £7,000. For the past 40 years the allowance has been fixed to plug budget gaps by officials in Whitehall, and then reworked to fit partisan calculations – a fact made plain by Alistair Darling's decision in the last Parliament to allow the threshold to become eroded by inflation. The allowance is not derived from any analysis of what people actually need, the administrative cost of collecting tax, or any notion of the disincentives to enter the workforce that high marginal tax rates create for those on low earnings.

This report argues that the Treasury should set the tax threshold by pegging the tax-free allowance to a democratically agreed level – one that represents what we as a society think is required to support oneself to the bare minimum acceptable standard of living. That is exactly what the Joseph Rowntree Foundation's minimum income standard is designed to establish. This research used a combination of democratic citizens' juries informed by expert evidence to ascertain the level of income people think is required to afford a minimum acceptable standard of living in Britain today. The research methodology used was explicitly democratic, extremely thorough and is summarised in box 1.

Box 1

How the Joseph Rowntree Foundation calculates the minimum income standard

The minimum income standard was set through a structured consultation with hundreds of participants selected to come from widely different backgrounds. The process went beyond a simple survey, combining the leading methodologies for assessing need, expert-led and public-led, in the following stages:[26]

1 Definition

Eight groups of six to eight people agreed a definition of 'acceptable minimum'. Crucially, the group defined the acceptable minimum as being beyond 'survival' requirements for food, shelter and clothing. They decided that:

- A minimum income standard in Britain today includes, but is more than just, the minimum income required to provide food, clothes and shelter. It is about having what you need in order to have the opportunities and choices necessary to participate in society.
- *Therefore the minimum income standard is supposed to provide not only adequate income to pay for what is needed for survival but also to maintain mental and emotional wellbeing by permitting some of the choices and income required to enable social participation.*

2 Setting budget headings and detailed budget break-downs

A second set of groups listed the broad headings of what was needed to reach that minimum for 15 different kinds of households. These budget setting groups then agreed a list of items and services within each category of the budget needed by each demographic. The budget setting groups were drawn from the demographic under discussion.[27] *Thus, the budget for a single female pensioner was developed by other single female pensioners (of all incomes).*[28]

3 Costing the baskets

The research team costed each basket at a range of high street outlets agreed by the groups.

Table 1 **Results of the Joseph Rowntree Foundation's research into the public consensus of the minimum income standard (per week)**

	Single person, no children (£)	Couple pensioner (£)	Couple plus 2 children (£)	Lone parent + 1 child (£)
Food	40.34	53.25	97.47	47.05
Alcohol	4.38	7.40	6.06	3.48
Tobacco	–	–	–	–
Clothing	7.64	9.93	29.26	16.41
Water rates	4.71	5.56	5.45	7.38
Council tax	13.33	17.77	20.73	15.55
Household insurance	1.79	1.65	2.23	1.99
Fuel	9.00	10.62	18.49	16.43
Other housing costs	2.29	3.61	7.26	2.12
Household goods	9.50	11.12	17.39	16.37
Household services	9.99	9.07	13.21	6.72
Childcare	–	–	186.98	135.05
Personal goods and services	8.40	23.65	27.39	19.47
Motoring	–	–	–	–
Other travel costs	17.03	4.65	35.02	17.16
Social and cultural participation	29.73	43.21	90.08	40.16
Total excluding rent	158.12	201.49	557.03	345.35
Rent	52.30	64.43	69.40	64.02
Total including rent	210.42	265.92	626.43	409.37
Total including rent but excluding childcare			439.45	274.33
Total excluding rent and childcare	158.12	201.49	370.05	210.31

4 **Initial expert check**
These budgets were checked with experts on nutrition, heating, housing and so on.

5 **Review**
Ten further 'check back' groups scrutinised the costed budgets.

6 Combining
Where appropriate, budgets for individuals were combined to produce budget standards for family types.

7 Anomaly check
Researchers checked for anomalies in budget patterns.

8 Geographic check
Finally, three further groups reviewed the budgets to check they were affordable in different regions and for households in rural as well as urban areas. Housing stood out as the main commodity for which costs vary widely. Childcare costs also vary considerably across the country. Therefore, the minimum income standard budgets exclude housing costs and childcare so these can be added as variable costs for real households.

9 Final review
A further three groups discussed and approved the results a final time.

Table 1 summarises the results of this calculation of the minimum income standard.

This minimum income standard is not predicated on either an absolute or a relative measure of requirement as usually defined. Rather than plucking a figure – relative or absolute – out of thin air, the minimum income standard is grounded in a deep understanding of the public and expert consensus on the real requirements of people to avoid social isolation – incidentally a figure well above the current official relative definition of poverty for most groups. It is relative only in so far as it will change in accordance with public attitudes. So although there is a valid debate to be had about whether absolute or relative measures are more accurate, whichever is correct, raising income to the minimum income standard will help poor families.

The Joseph Rowntree Foundation's 2009 revision of the minimum income standard updated the cost of goods and included exploratory discussions with members of the public into the possible effect of recession on what people would define as a minimum. Participants in these discussions came to very similar definitions of the minimum to the original pre-recession research, and drew up almost identical lists of items regarded as the minimum standard to participate in society.

For full details of the minimum income standard process visit www.minimumincomestandard.org/.

Millions of people fall short of the minimum income standard

Millions of people do not reach the minimum income standard. New research for Demos indicates there are around *14 million children and working aged adults living below the minimum acceptable standard of living in Britain today*[29] and more still if one includes pensioners, despite the fact that 3.77 million are working (or children in working households). This situation is intolerable.

This problem has not received the attention it deserves. Rightly there has been a huge policy focus on the very poor over the past 13 years – those falling below the official breadline (currently defined as 60 per cent of median income). But as a society, our definition of need should not stop there. Few people would now agree with the view that bread, water and shelter alone are all that is required to keep one at a minimum acceptable standard to participate in society.

The breadline is relative and therefore, like the Income Tax personal allowance, not based on a holistic understanding of need. In fact, the public consensus established by the Joseph Rowntree Foundation's research found the minimum income requirement is considerably higher than the breadline (table 2).

There are millions of people living just above 'survival' poverty on the breadline, but falling far from the minimum income they need to play a normal role in society. If we accept the minimum income standard methodology as a better definition of the deprivation we seek to eradicate than just the official breadline, then policy makers have been systematically undercounting the extent and severity of social exclusion caused by low incomes in Britain for decades.[31] New research by Demos indicates that, even before factoring in housing costs, as many as *5.2 million working age children and adults fall into what we might define as this 'twilight zone'*

Table 2 **Minimum income standard compared with median income (per week)**[30]

	Single working age £	Pensioner couple £	Couple + 2 children £	Lone parent + 1 child £
a) Before housing costs: estimated median	263	393	550	342
Minimum income standard excluding childcare and council tax	207	260	439	271
Minimum income standard as percentage of median	78%	66%	80%	79%
b) After housing costs: estimated median*	193	332	465	259
Minimum income standard excluding childcare, council tax, water rates and rent	148	187	362	197
Minimum income standard as percentage of median	77%	56%	78%	76%

between 60 per cent and circa 78 per cent of median income: the gap between the breadline and the minimum income standard. (Note too that although almost all figures in this report are after housing costs (AHC), the format published in the original minimum income standard research, the figures in Tables 10–12, Tables 16–24 and Figures 17–20 are before housing costs (BHC). This is because the housing cost data in the Family Resources Survey from which they are calculated is only available at household level so it is not possible to do the calculations for households made up of more than one family, of which there are a few thousand in the Family Resources Survey.)

Table 3 **The gap between the minimum income standard and earnings on the minimum wage**

Gross weekly earnings required to meet the minimum income standard, 2009[33]	Single working age	Couple + 2 children excluding childcare	Lone parent + 1 child with childcare
Minimum income standard (including rent and council tax) (£ per week after housing costs, before tax)	£220.33	£460.13	£426.59
Gross earnings required (£ per week after housing costs, before tax)	£265.79	£530.02	£232.48
Hourly wage rate for 37.5 hour week	7.09	14.13	6.20
National minimum wage (2008/9 level), hourly	5.73	5.73	5.73
% needed over current minimum wage	24% more needed	147% more needed	8% more needed

So for progressive Conservatives, although it is right to support those in dire need, it is absolutely vital that the new government acts to support – or at least not hinder – those living in this twilight category.

Many of those in the 'twilight zone' are in work

It is sad, but perhaps not surprising, that most working age people out of work do not reach the minimum income standard.[32] For a single person on income support, benefits provide less than half the minimum income standard.

More shocking is that many people in work still do not earn enough to reach a minimum socially acceptable standard of living (table 3). *A single person working full time cannot meet the*

Table 4 **The gap between the minimum income standard and earnings for younger workers on the minimum wage**

Worker age[34]	Over 22	18–21	16–18
Minimum hourly wage	£5.80	£4.83	£3.57
Minimum hourly wage as percentage of minimum income standard for a single person per hour (£7.09), before tax and national insurance	82%	68%	50%
Gross annual wages on minimum wage[35]	£11,310.00	£9,418.50	£6,961.50
Fall short of minimum income standard (£13,859) after tax and national insurance contributions	£2,549.00	£4,440.50	£6,897.50
Shortfall from the minimum income standard	9%	14%	21%
Hours of work per week needed to meet minimum income standard	46	55	75
Hours of work per day needed to meet minimum income standard (5-day week)	9	11	15
Sample working day (hour off for lunch)	In at 8am, leave 6pm	In at 7am, leave 7pm	In at 6am, leave at 10pm

minimum income standard on the minimum wage. Though the minimum wage brings low-paid workers close to the minimum income standard, tax and national insurance then drive it far out of reach. They would need to earn £7.09 an hour before tax, national insurance, housing costs and benefits to reach this weekly standard, but the minimum wage (in 2010) is only £5.80.

As a result, nearly two million households, made up of 3.77 million people under retirement age – 27 per cent of the total – fall below the minimum income standard, despite being in work.

Wages have to be much higher again for those single-earners who support a family, even when taking account of benefits. A single-earner couple with children would need to earn well over double the national minimum wage to reach the minimum standard. A lone parent, helped by tax credits, would get closest to reaching the minimum income standard on the minimum wage; if she had no childcare costs, her income on the national minimum wage would exceed minimum income standard as long as she worked at least 30 hours. However, for the many lone parents caring for children this is not feasible. If they work fewer hours (which disqualifies them from a tax credit bonus for working over 30 hours), as many do, most single parents need a wage much higher than the current minimum wage to reach the minimum income standard.

The situation is even more acute for younger workers living away from their parents who need to work as much as 75 hours a week to meet the minimum income standard on the national minimum wage (table 4).

In any case, in April 2008 17,000 jobs were held by 16–17 year olds who were earning less than the then minimum wage of £3.40 per hour, while 47,000 jobs were held by 18–21 year olds with pay less than £4.60 per hour.[36]

Life in the 'twilight zone'

Recent ethnographic depth research paints a picture of life below the minimum income standard.[37] As a means of saving money, some mothers will buy convenience food which they know their children will eat rather than buy food conducive to a healthy diet which may in fact go to waste.[38] A common strategy to save on spending was parental sacrifice, especially by mothers, in order to protect children from the full impact of inadequate material resources.[39] Parents on a low income are often determined to give the best they can for their children, even when this means they themselves will have to go without.[40] But this carried with it a substantial strain. One mother in a Joseph Rowntree study reported:

The bairn always gets plenty [of food]… I see to that. But I do not think I do. Well I know I do not, not really. That is why I am tired all the time and ratty, get dead ratty these days… Cannot be bothered nowt.[41]

Researchers in Kent who shadowed eight low-income families saw how they frequently visited the Sure Start centre just to eat the free food because otherwise they could not afford to feed themselves. The study noted that 'during the research period it became clear that many of these parents would endure hunger for quite long periods to ensure that their children ate sufficiently well'.

A recent BBC news story which followed a disturbing MIND report on debt and mental health carried the following quote from one of the respondents:

If I buy a tin of tomatoes for 15 pence, I have to budget for it.[42]

This picture is backed up by the very latest research into low earners' experiences of the recession by the Resolution Foundation.[43] One member of a focus group of 21 participants reported:

Even the cost of basic things such as food, water and electricity has risen; I feel that practically all my income goes on this basic stuff.

A number of group members said they had reduced the time they had their heating on to save money. One participant related how they got into bed to keep warm to save on heating bills. They explained 'It's either heating or eating.' Other members of the group highlighted short-term savings that had potential long-term costs:

We had to sell one of our cars to reduce costs – we used to have two – and now my partner has to drop me off an hour early for work because we begin work at different times. It used to be much easier when we had two cars.

Reduced household income was perceived as having a negative consequence on people's health, owing to the cost of healthy food. A number of participants felt that healthy food was more expensive than cheaper food and that financial necessity was forcing them to adopt a more unhealthy diet:

I can't afford the healthy foods. They're too expensive so I buy cheap stuff which is bad for you.

Several participants described cutting back on non-essentials. For example, a number of people said they were no longer able to go on holiday or socialise as much because they lacked disposable income. The social links and networks forged through clubs, pubs and seeing friends and family were jeopardised in some cases through lack of time as well as lack of money:

I think the recession has impacted on people's social lives. I've noticed people haven't been going out as much as they used to; they're going to the off-licence and taking drink back home.

It is important to note that all these quotations are from people still in work, not in receipt of unemployment benefits. One crystallised working life below the minimum income standard saying:

[I have] no life, not living, just existing. No change left after bills, no holiday and no quality of life.

The following hypothetical case studies illustrate the choices those on very low incomes have to make.

Vicky

Vicky, 31, lives on her own in a one-bedroom flat in Glasgow, and works full time in a shoe shop for £6 an hour, earning a total of £225 a week or £11,732 a year. This would be just enough for her to meet her minimum living requirements, but every week she pays out £33 in tax and national insurance, and receives back only £11 in tax credits. The result is that rather than having a few pounds to spare each week, she is £17 short of what she would need for the 'minimum'. This is a large amount to cut back on, since it represents about *an eighth of her total budget*. It is for example nearly twice her fuel bill, and over two-thirds what she needs as a minimum to buy food each week, other than eating out.

Groups in the research thought that a £10 weekly budget for eating out was a reasonable minimum for a single person, as part of a budget of about £20 for leisure activities including things such as swimming or going to the cinema. Thus, if Vicky squeezed her budget it could either mean she went without some physical necessities or she was unable to participate in society, for example by almost never spending money on going out, making it hard to maintain friendships.

Lindsey

Lindsey, 25, is raising her son Aaron on her own. They live in a two-room flat in Belfast. Until recently Lindsey stayed at home to look after Aaron, but found it hard to buy him the things he needs, so now she works at a call centre for three days a week, earning £9,000 a year. To do this she pays a childminder £81 a week to look after Aaron. She pays £17 a week in tax and national insurance, and gets just over £191 back in child benefit and tax credits from the state, including a £65 contribution towards childcare costs. Despite these payments, she is still £28 short of what she needs for a minimum acceptable standard of living.

Lindsey's sister fell into debt last year, and Lindsey is worried she might have to do the same. Thanks to generous rises in tax credits over recent years, Lindsey is far better off than she was before she worked: then, she was £74 a week short of what she needed, even without having to pay childcare. Now, by being very careful and spending almost nothing on going out, she just manages to cope from week to week without going into debt. However, she is concerned that she is not able to put anything aside for long-term purchases, such as replacing things that break down or being able to spend extra at Christmas or on a holiday. Ideally, she would like to put aside £10–15 a week for such spending. She has looked into how much more she would need to work in order to do this. The problem is that for each extra £1 she earns, she will have to pay 31 pence more in tax and national insurance, and also will lose 39 pence in tax credits, leaving only 30 pence extra. If she extends her hours to earn an extra £1,000 a year, she will keep less than a third of this amount, or about £6 a week.

Tony

Tony, 55, lost his job in a car plant a year ago, and his redundancy money only lasted a few months. He would now like to retrain, but is reluctant to get into debt, and does not know how he could afford the course fees, even though they are modest. His wife, June, is working in a travel agent's earning £20,000 a year but this only just covers their main living expenses even though they have cut out holidays and rarely go out socially. Because June pays £82 a week in tax and national insurance they end up £22 a week short of what they need for a minimum standard of living.

Barry and Jill

Barry and Jill live with their two children Nicola (13) and Lee (9) in a three-bedroom terraced house in Swindon. Barry works full time as a security guard, earning £225 a week. Jill is a care assistant, working three days a week and earning £190. They spend £59.50 a week on after-school and holiday childcare. This family's earnings are supplemented by child benefit and child tax credit, as well as a contribution of £20.55 to childcare costs by the childcare element of the working tax credit, but they earn too much to get any general working tax credit. They pay £55 tax and national insurance a week between them, and their disposable income is £50 below the level needed (£560 a week, including rent, council tax and childcare) for a minimum standard of living.

This will pose some difficult choices for Barry and Jill. The £50 shortfall is over half of the family's food budget. Research shows that in some families in this position, parents cut back on meeting their own basic needs (eg by skipping meals) in order that their children can have what they require. If they have to cut back on items of social participation, this might include things like joining sports clubs or Cubs for nine-year-old Lee (£7 a week), parents going out for occasional coffees, meals, cinema or other leisure activities (£35 a week between them) or a basic annual holiday in the UK for the family (a week self-catering in the UK, requiring £12 a week to be saved through the year).

Below the minimum income standard this couple cannot even afford one night a month to themselves for a cheap meal and cinema ticket. If politicians are serious about tackling the broken society they need to work to release those working hardest for the least from the strains associated with living below the minimum income standard.

2 Living below the minimum income standard is breaking Britain

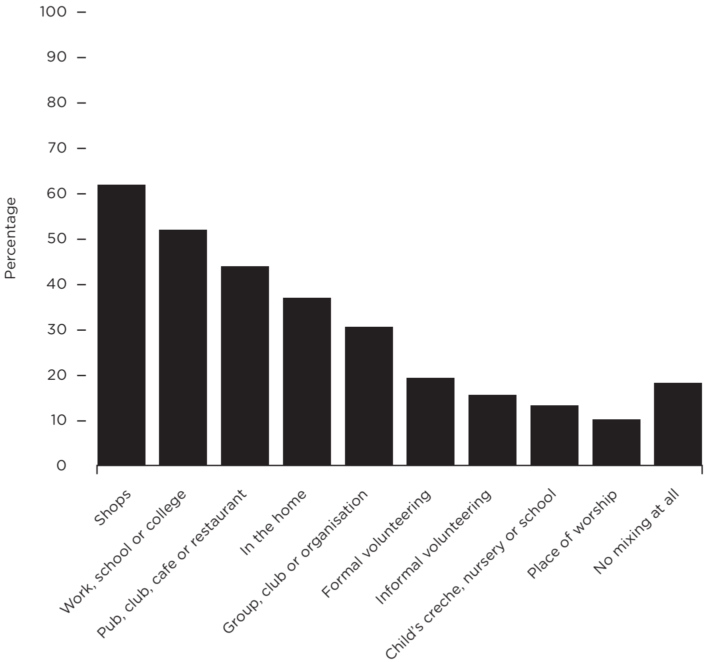
For progressive Conservatives helping people to escape sub-minimum income standard incomes is not just a matter of compassion. There are powerful social arguments for acting to tackle low income. The effects of falling below the minimum income standard are severe, not just for individuals but for communities and society too.

Many commentators have argued that British society is broken and 70 per cent of people agree.[44] Britain certainly has a severe and growing problem with social fragmentation, isolation and exclusion:[45] 56 per cent of people say that they hardly recognise the country they are living in any more[46] and 82 per cent think it is time for a change.[47] Trust in others has fallen steeply in Britain over the past 50 years. By the turn of the last century only 31 per cent of people agreed that 'generally speaking most people can be trusted', compared with 56 per cent in 1959.[48]

Older people are becoming particularly cut off from the rest of society. Half of all people aged over 75 live alone. *Nearly half of all older people consider the television to be their main form of company*.[49] Over half a million older people spent Christmas Day alone in 2006. Just over 1 million older people (11 per cent) in England always or often feel lonely and 12 per cent of older people feel trapped in their own home.

Britain has become less participatory too. Levels of volunteering have remained static since 2001, and one-fifth of the British public have never volunteered.[50] Being actively civically engaged is also static (at just under 40 per cent) and only one in

Figure 1 **How and when Britons mix with others**



Source: Home Office, Citizenship Survey.

four people have taken action to solve a local problem.[51] This means that, on average, we spend a mere four minutes per day volunteering and eight minutes helping others.[52] As a result, a sense of belonging is not universal – only three out of four people feel that they belong in their neighbourhoods.[53] The Home Office Citizenship Survey shows British people mix little outside enforced interactions like the high street, work and school (figure 1).[54]

As a result 'even the weakest communities from 1971 were stronger than any community is now' according to Professor Dorling of the University of Sheffield.[55]

It does not have to be this way. Decline is not a universal phenomenon in developed countries. Compared with other European and OECD countries the UK consistently ranks poorly on social capital indicators. Levels of trust in Norway are 65 per cent compared with the UK's 31 per cent. The UK is in the bottom four of 22 nations on levels of trust, belonging and how close we feel to our neighbours and the third from bottom among Western European countries for personal and social wellbeing.[56]

It is not too much to suggest that *these problems may be a direct consequence of allowing millions of people to slip below the minimum income standard*. Indeed that is the definition of the standard: the minimum income standard is the minimum level required to participate in society. Below this level, the poorest in work cannot participate fully in society. Being unable to participate means you do not have the resources to go out socially, cannot afford a bus to work, cannot take even a modest holiday every few years, cannot do work experience, buy books, see a pantomime at Christmas, join a gym, afford a hobby, visit a cafe or save for the future without going without food; and all this despite going out to work. Reaching the minimum income standard does not enable you to do all these things every day, but it does enable you to choose some of these things that most of us consider a normal part of everyday social life. How can we build a society of strong couples, regular exercisers, flourishing pupils and rounded school leavers without such necessities of social participation?

Those in lower socio-economic groups have only 45 per cent as many formal associations as those of the middle classes.[57] The correlations with levels of educational achievement show similar trends: people with qualifications are more likely to do and receive favours from their neighbours and have a wider network of people to turn to in times of crisis.[58] Although an already worrying 17 per cent of older people have less than weekly contact with family, friends and neighbours, Ipsos MORI found that the problem was three time more common among older people who are on low incomes.

Helping people to reach the minimum income standard through their own hard work is an essential part of fixing broken Britain and the bedrock of building a Big Society. It is time to act to ensure everyone in work has the resources needed to participate in society.

Low income in childhood can inhibit character development for adulthood

Not only is social isolation breaking our communities, it is harming children's ability to develop into rounded self-sufficient citizens in later life. The development of character capabilities and life skills is strongly related to economic background, especially in childhood. Not all capabilities depend on income, but many do. Figure 2 illustrates this relationship.

The influence of wealth takes several forms. Wealthier families are able to buy positive developmental experiences for their children (activities, music lessons etc). Their outlook and character are developed by foreign holidays, frequent engagement with culture and the strong and extensive social networks within the professional middle classes.[59] Richer parents can also ensure a better quality of education for their child, through private schooling, extra tuition or moving to the right catchment area. School quality is strongly related to property prices, with a difference of 10 percentage points in a school's league table adding at least 3 per cent to the price of a house located next to it.[60] In the USA, Zhan and Sherrraden found that mothers who were homeowners or had savings of $3,000 or more had higher expectations of their children's attainment.[61]

Apart from the lack of raw purchasing power of money, low income can also cause considerable perceptual fears, uncertainty and anxieties, which harm both parent wellbeing and child development. Financial security also impacts on stability and security in the home and levels of stress in children.[62] A large body of work shows that access to resources in childhood, including owning a home (particularly duration of home ownership) have a positive impact on emotional wellbeing

Figure 2 **Capabilities most influenced by financial factors**

Money more important		Money less important
Purely financial factors	Interrelated factors	Purely non-economic factors
Debt Inadequate savings and assets (home ownership, pensions, etc)	Social and contextual issues	Disability
	Social networks	Geography
	Bridging social capital	
Low income	Quality of family and parents' relationships	
	Cultural capital, manners, civility	
	Healthiness of lifestyle	
	Capabilities	
	Mental health	
	Character – diligence, agency, etc	
	Poor education	
	Low skills	

Source: Demos analysis. Full survey information see Lexmond & Reeves, *Building Character* and Sodha, *Ex Curricula.*

throughout adolescence and later life including: likelihood of teen pregnancy,[63] fewer behavioural problems[64] and less likelihood of depression and conduct disorders.[65]

The repercussions of poverty for children growing up in low-income households are profound and felt throughout their social and familial lives.[66] Yeung and Conley found that wealth could predict parental warmth and the amount of time parents spent with children.[67] Working in a low paid job means having to make difficult choices between employment and caring for children – a dilemma particularly acute for single parents. Contact is key. Children whose mothers start working full time, nights or irregular hours reported a negative change in the quality of what time they did spend together,[68] and it was common for children to miss their parents if they had to be out at work for long hours.[69]

Outside the home, growing up in a low income household in an affluent society can also have a profound effect on children's confidence and wellbeing.[70] Children feel the stigma of a low income, despite the best efforts of their parents to alleviate its impact and to protect them from bullying and teasing.[71] In a well-known study researchers asked children what would happen if they went to school without the 'right' clothes to wear. The children replied that 'you would feel left out'; 'you might get picked on or something like that and you feel really embarrassed'; and that other children 'hassle you. They say nasty things like "you get your shoes from the tip", and stuff like that.'[72]

Indeed, research in 2008 demonstrated that the stigma of poverty, the fear of being seen as poor, and being identified as an 'other' by their peers, can all have considerable effects on both child and parents' self-esteem.[73] One mother in the same study who could not afford Coca-Cola, bought a supermarket brand instead. But to protect her child from teasing she decanted the cheap drink into an empty Coke bottle.[74] As one father put it:

Nothing hurts you more than when your kids ask for something and you look around all four corners and you cannot see any way of getting it. At that particular time you feel just like picking up a knife and slitting your throat… Sometimes you wish you did not have kids… [But] I love them more than anything else in the world.[75]

Sobolewski and Amato have shown how lack of access to resources contributed to parental anxiety, which in turn destabilised relationships between the family at home,[76] a point made by another study in which a struggling mother reported that:

Little things that never mattered before are suddenly major issues and you fight over them. I fight with him [her husband], I shout at the kids, he does *as well and the kids cry. They probably do not argue any more than they used to, but because we are here all the time it seemed like it.*[77]

Financial poverty can add considerable stress to day-to-day relationships, which can increase the likelihood of family breakdown. Relate have found that money rates as the top cause of arguments among couples.[78] During the first five years of marriage, the most common and intense source of conflict among couples under the age of 30 is debt brought into marriage, according to a large national study conducted in 1999 by the Centre for Marriage and Family at Creighton University in Omaha.[79]

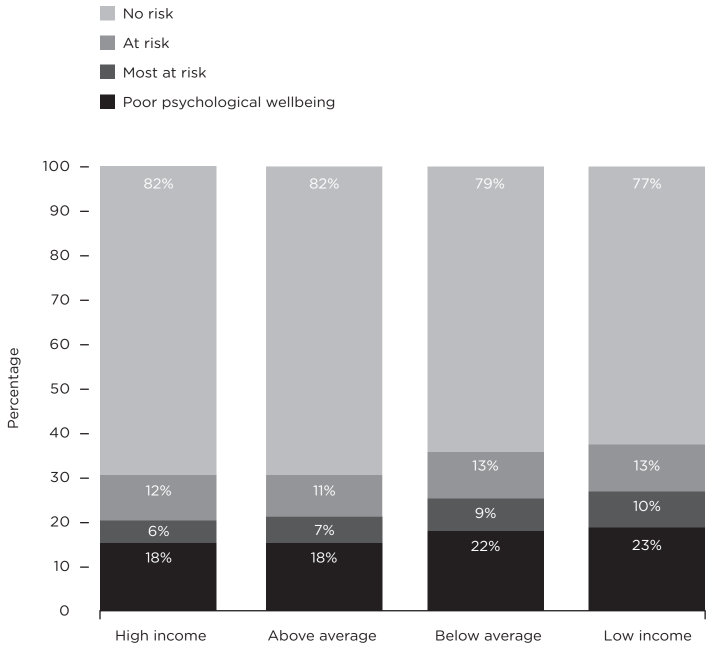
A recent study of the lives of a group of single parents who moved into work between 2003 and 2007 found that the incomes from employment were insufficient to avoid many of the parents having to go into debt, with around half in this situation.[80] In late 2009, 61 per cent of 'low earner' households reported having an outstanding debt: 32 per cent had secured debts and 53 per cent had unsecured debts. Total debts among all low earner households averaged £29,300, rising to £48,000 among just those with debts.[81] Partly as a result, 13 out of 19 women in the third wave of interviews conducted by the researchers were experiencing stress or depression.[82]

Recent research has highlighted the serious psychological effects associated with the strain of living on low incomes (figures 3 and 4).

The rate of poor psychological wellbeing[84] increased from the average 20 per cent to 23 per cent when isolating those on low income.[85]

All these factors show that wealth makes it easier to build an effective style of parenting. In landmark research published in 2009, Demos identified four distinct 'parenting styles', which define the parental approach to child rearing.[86] Children with 'tough love' parents – who combine warmth with discipline – were twice as likely to develop good character capabilities by age five as children with 'disengaged' parents, and did significantly better than children with 'laissez faire' (relaxed) or 'authoritarian' (strict but lacking warmth) parents. The report demonstrated that it is not resources in themselves that define a

Figure 3 **Psychological wellbeing by income,[83] 2006–7**

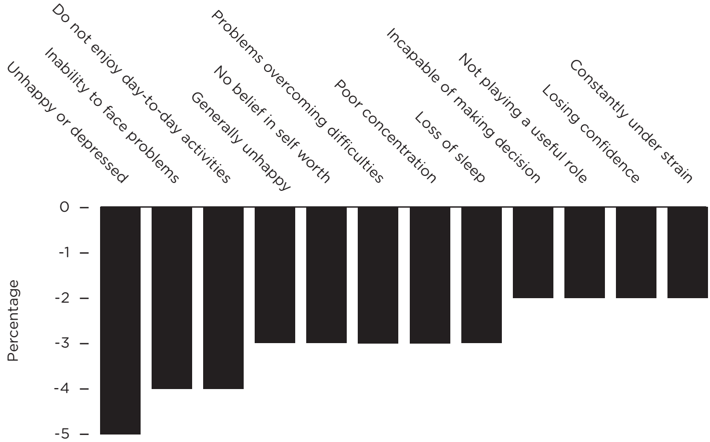


Source: adapted from Watts et al., *Sinking & Swimming*, 96–7.

child's life chances, so much as the way in which they impact on a parent's ability to parent well. One of the key findings of this report was that poorer families are simply much less able to provide the effective 'tough-love' parenting that children need. *Building Character*[87] found the following:

- Children from the richest income quintile are more than twice as likely to develop strong character capabilities as children from the poorest quintile.
- 'Tough love' parenting is less frequent in low-income backgrounds. Although the 'love' element was consistently

Figure 4 **The difference in psychological wellbeing reported by people on low income compared with high income earners**



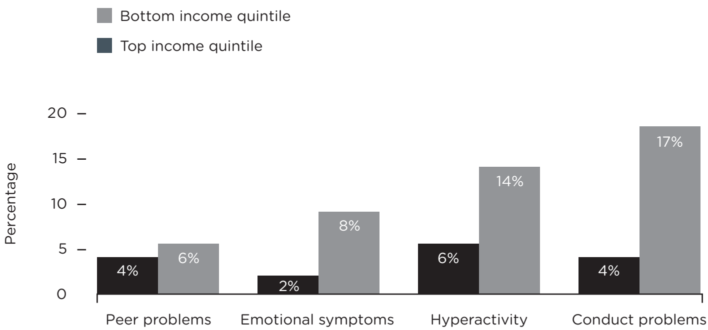
Source: Watts, *Sinking & Swimming*.

distributed throughout economic groups, consistent rule setting and authoritative parenting was associated with wealthier families.

- When parental style and confidence are factored in, the difference in child character development between richer and poorer families disappears.

Another way of saying this is that poorer parents are often less confident (perhaps because they are often younger) and experience more instability and stress, which makes them less likely or able to enforce rules consistently in the home, which explains why they made less effective parents. This perhaps explains why there is such a strong correlation between low income and behavioural problems in young children (figure 5).

Figure 5 **Behavioural difficulties in poorer children**[88]



Source: Sodha, *Ex Curricula*.

Strikingly, disadvantages faced during childhood have a persistent negative impact on one's job prospects in adulthood. Data examined by Blanden and others explored the relationship between deprivation in childhood, educational attainment and labour market performance.[89] Interestingly, they found that poor school attendance and growing up in a family in financial distress have more of an impact on economic success in later life than the formation of the family, for example, if they are in a lone parent or couple family household.[90]

This 'character gap' is getting wider. In *Freedom's Orphans* Margo et al. show how trends in parental spending on activities for children increased radically in the last ten years in middle-class families, creating a socialisation divide with poorer families unable to offer their children the same quality of structured sport, art or drama and music-based activities.[91]

This effect is becoming more acute as the economy moves from hard to soft skills. Evidence presented in *Freedom's Orphans* suggests that although the development of character capabilities among children born in 1958 was not related to income, it was strongly associated with income among those born in 1970.[92] The implications of these findings are potentially profound, since it appears that *the opportunities to develop character capabilities narrowed in lower-income households, just as those capabilities became more important to life chances*.

Therefore income matters now as never before, because income is an essential prerequisite both to participating in society and full individual character development. This is not an ideological view, or the poverty lobby's view; it is the conclusion of an extensive academic and scientific research base, and supported by the public, as demonstrated in the 39 citizen research groups by the Joseph Rowntree Foundation in 2008 and again in 2009 attempting to establish a minimum income standard.

So enabling more people to reach the minimum income standard is not simply a technocratic objective of straightening the Lorenz curve. It is fundamental to building stronger communities, stronger families, stronger people.

3 Policy options for enabling more people to reach the minimum income standard through work

How can government enable more people to reach the minimum income standard?

Criteria for selection and options for reform

A progressive Conservative approach to raising more people to the minimum income standard should be judged against five criteria:

- *Strength of message*. The right reform should create a strong as possible direct connection between effort and reward, by narrowing the gap between earnings and final income.
- *Impact*. How much does it benefit those below the minimum income standard who are in work?[93]
- *Affordability*. Any reform must be realistic in the current fiscal climate.
- *Simplicity*. Any reform should be simple to understand and administer.
- *Self-reliance*. For progressive Conservative, fiscal reform should be judged according to how well it promotes a culture of self-reliance, as measured by the proportion of one's take-home income which you generate yourself, not from the state.

These criteria are not easily reconciled. It is not possible to achieve a perfect result for every criterion. However, an important conservative principle is pragmatism. The perfect should not be the enemy of the good. This report seeks to define the best fit between these conflicting priorities.

Obviously there is a gamut of policy options which have a more or less direct bearing on the lives of low and middle income earners in general, such as transport or skills policies. Additionally, the current government is committed to a particular avenue to raising the Income Tax threshold – although, as is discussed elsewhere in this paper, it differs in many ways from the proposals laid out later on here.

In the long run, the biggest impact must derive from macro-economic policy. For 30 years the UK economy has been based on a model of 'ugly growth'. Growth was there to be sure; but it was excessively dependent on just a few industries, in just a few regions. The key task of the next 30 years will be to build a new model of macro-economic growth which provides more stable, sustainable, enjoyable adequately paid work for more people in more sectors in all regions. This is certainly an area for further research in the future, and one Demos plans to return to.

However, within fiscal policy there are five policy options to raise take-home income:

- Raise tax credits.
- Promote a living wage.
- Cut rates of direct tax.
- Cut rates of indirect taxation.
- Raise the level at which Income Tax begins.

Tax credits alone are not the answer

For progressive Conservatives, higher tax credits alone are not the answer. Obviously, tax credits have had benefits. Notionally, they are a very efficient way of addressing poverty, because they are tightly targeted, so they have had a major impact in reducing poverty for minimal cost to the Exchequer. We cannot easily do without them without huge additional cost.

However, precisely because they are so targeted, tax credits are 'complicated and time consuming to claim, expensive for government to administer and prone to significant fraud and error', according to the respected think tank the Institute for Fiscal Studies.[94] The administrative cost of the tax credit system was estimated at £587 million in 2006/7. HMRC estimates that claimant error and fraud led to mispayments of between £1.04 billion and £1.30 billion in 2004/5 alone.[95] Policy changes announced in the 2005 pre-budget report have helped the department to reduce recoverable overpayments from £1.9 billion to a still enormous £1 billion annually, but HMRC estimates that in 2006/7 claimant error and fraud led to incorrect payments of an even higher level of between £1.31 billion and £1.54 billion (7.2 per cent to 8.4 per cent of amount paid out). This led the comptroller and auditor general to qualify his opinion on the HMRC trust statement for the sixth consecutive year.

This complexity has also led to overpayment and claw back by the department itself. An estimated 1.9 million families end up receiving tax credit overpayments each year, more than double the 750,000 margin for overpayment error anticipated when the scheme was introduced.[96] According to the House of Commons Public Accounts Select Committee, HMRC overpaid £7.3 billion in the first four years of the scheme and underpaid more than £2.0 billion.[97]

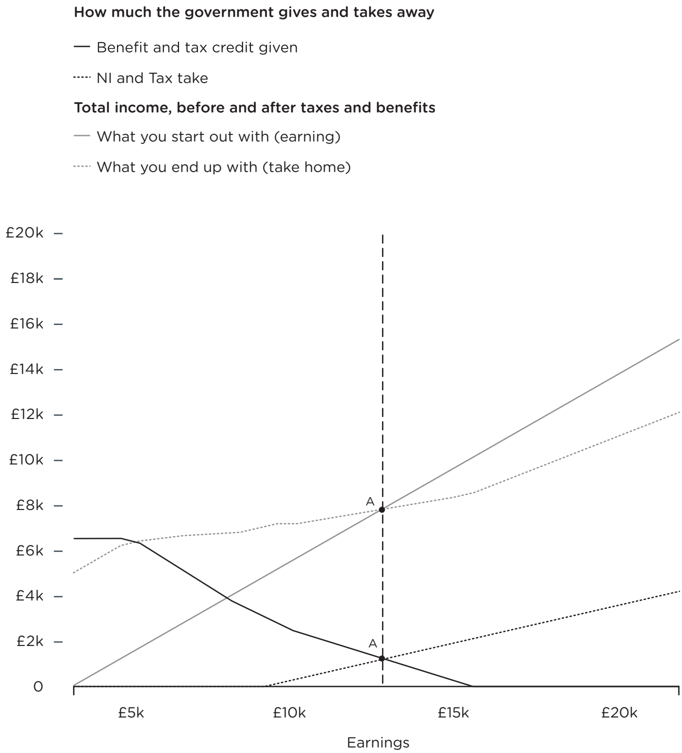
This creates significant anxiety in those claiming tax credits. According to the Committee,

Many hundreds of thousands of people are constantly worried about incurring overpayments. The Department has not given claimants the support they need in making claims and reporting changes in circumstances, and it has assumed too much on the part of claimants in their understanding the tax credits system.[98]

As one claimant in a Kent study put it:

Why on earth have they done this? How could I know they were overpaying me? I didn't do anything wrong… I just filled in the forms and they gave me the money. Now they are asking for it back? But where am I going to get the money from? To be honest I have just added it to the pile of debts I can't pay. They can ask me all they like. I don't have it. If they take it straight out of next year's payments then there is nothing I can do… but it doesn't exactly help does it?

Figure 6 **How give and take affects actual disposable income**



A = At this point tax credits and tax are purely a bureaucratic exercise. Someone earning £12,200 pays in and received back the same amount: £1,300

Source: Demos analysis by Donald Hirsch.

As a result non-take up of support remains a key problem.[99] Early evidence suggested that tax credits actually increased income instability.[100]

In a sense, working tax credits are no longer targeted: their main advantage. Rather than going to specific groups in need of greater support, all low wage earners now receive some level of working tax credit. This paper argues that tax credits should be focused on what they do best: providing targeted support to certain groups, rather than as a panacea for all low earnings.

Moreover, *tax credits are fundamentally unconservative*. They take with one hand and give with another, as shown in figure 6. This creates a passive mindset. Money given back appears as a hand-out, rather than what it is – essentially a refund.

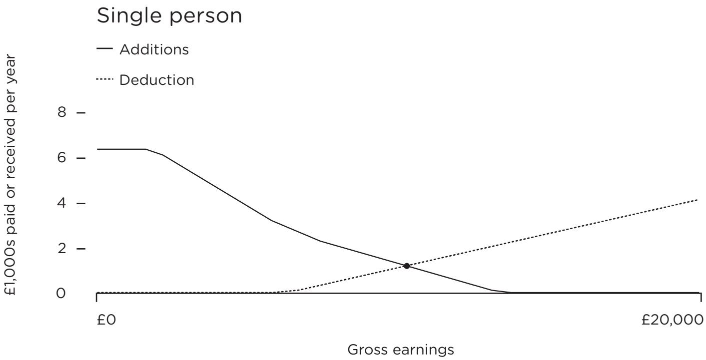
A single person earning £10,200 a year pays £1,300 a year tax and national insurance, and falls short of the minimum income standard by a similar amount, despite getting over £1,300 in tax credits. For this person the distinction between earnings that are taxed and tax credits they receive is non-existent: they cancel each other out. The state simply takes with one hand and gives back exactly the same amount with the other. But for government and the individual this exercise is not cost-neutral. Both have to expend time and effort: the state to administer the scheme, the citizen to fill out the application simply to get their money back again.

Perhaps worse, those earning £10,400 to £13,800 are being taxed into falling below the minimum income standard. The tax burden exceeds the amount that they are short of to reach the minimum income standard (above this range, they reach the minimum income standard; below it, their tax liabilities are lower) (figure 7).[101]

For a single earner couple with two children, this range is far wider. Earning £16,700 a year, the family is paying £3,200 tax, and is short of the minimum income standard by the same amount. Under the current system of tax they have to earn £27,600 before they meet the minimum income standard level. Between £16,700 and £27,600 the tax burden is pushing this family below the minimum income standard (figure 8).

On the other hand, for the lone parent with one child, the situation is very different. Helped by tax credits, she needs to earn only £12,100 to support her family to the minimum income standard if she pays for childcare or £7,300 if she does not pay for childcare. But in the former case, if she is earning in the range £8,200 to £12,100 a year, her tax burden pushes her below the minimum income standard (figure 9).

Figure 7 **What the state gives to and takes from single low earning taxpayers as their income increases**



Note: these graphs slightly oversimplify by assuming full-time worker (30+ hours a week). Since someone working 30 hours at minimum wage earns about £9,000 a year, this will not apply at lower earnings.

*Working Tax Credit, Housing Benefit, Council Tax Benefit. Assumes £13.60 a week council tax and £60 rent.

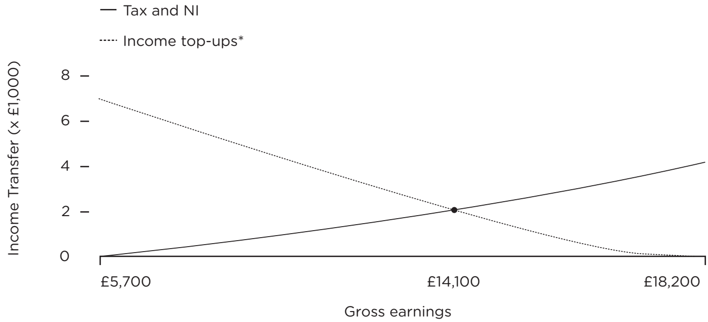
Source: Demos analysis by Donald Hirsch.

So for many people a large part of their earnings are taken away, mixed around Whitehall and mostly returned to them again. This give and take is not only excessively bureaucratic, expensive and prone to error, it is disrespectful. Progressive Conservatives assert the right of the individual to earn their own wage and keep as much of it as possible.

So, though there is still a role for tax credits, they fail the criteria set out for reform at the start of this chapter. Though they have substantial impact per pound spent and are therefore relatively affordable, tax credits are overly complex, clearly muddy the connection between work and reward and encourage dependence on the state. Therefore, the long-term government strategy should be to find ways to obviate the need for this Byzantine and overbearing system. Policy makers should aim to

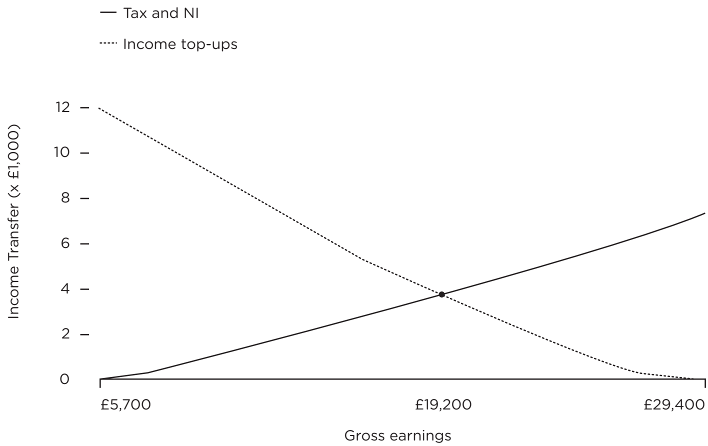
Figure 8 **What the state gives to and takes from low earning couples with children as their income increases (£ per year)**

1) Excluding Child Tax Credit



*Working Tax Credit, Housing Benefit, Council Tax Credit.
Assumes £26.10 a week council tax and £80 rent.

2) Including the child element of Child Tax Credit

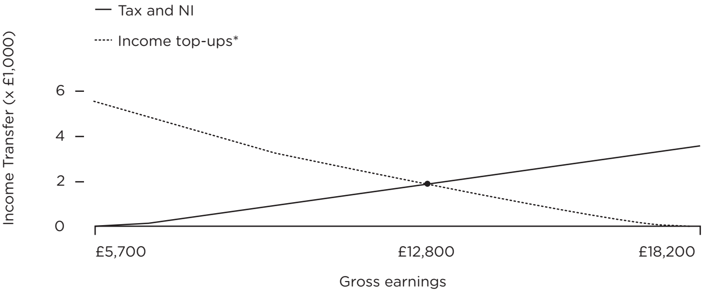


Note: The child element of the Child Tax Credit is paid at a flat rate to people on low incomes up to a certain level, then tapered away as income rises above this level. The family element, which is paid at a flat rate to everyone not eligible for higher rate tax, is not counted as an income-tested payment for these purposes.

Source: Demos analysis by Donald Hirsch.

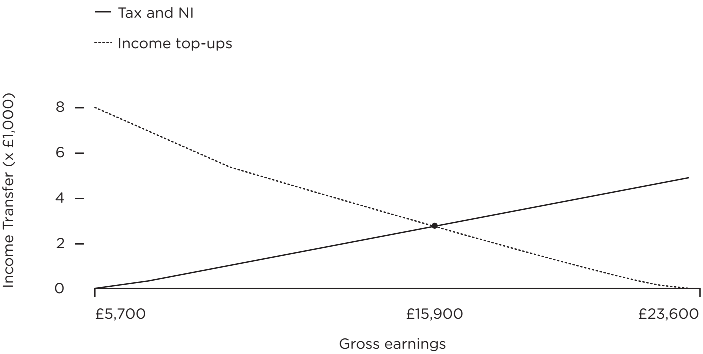
Figure 9 **What the state gives to and takes from a lone parent as their earnings increase (£ per year)**

1) Excluding Child Tax Credit



*Working Tax Credit, Housing Benefit, Council Tax Credit. Assumes £26.10 a week council tax and £80 rent.

2) Including the child element of Child Tax Credit



Note: The child element of the Child Tax Credit is paid at a flat rate to people on low incomes up to a certain level, then tapered away as income rises above this level. The family element, which is paid at a flat rate to everyone not eligible for higher rate tax, is not counted as an income-tested payment for these purposes.

move away from the current over-reliance on tax credits as the means of lifting most people out of working poverty. They should consider a new approach, one which consists of helping people to help themselves reach the minimum income standard by retaining more of their own wages and using tax credits more sparingly to top up wages where necessary.

Raising the minimum wage is only a partial solution

A second solution is to introduce a much higher minimum wage. A living wage meets many of the criteria laid out at the start of the chapter. It is simple, focused on the lowest earnings and encourages self-reliance. It also costs nothing directly to the Exchequer, (except as an employer itself), although obviously it has a substantial impact on the costs of labour for some types of business.

However, a living wage is only a partial solution. If implemented voluntarily, it will have only limited uptake. An alternative is for the public sector to set an example. The progressive Conservatism Project supports the concept of a public sector living wage, as Max Wind-Cowie argued in *Everyday Equality*,[102] but there remains the problem of promoting a higher wage for private sector workers.

A mandatory living wage is often opposed on the grounds that a higher wage cost might reduce employment overall. There was little detectable loss in employment when the national minimum wage was introduced in 1999. Moreover only a minority of low-paid workers are in sectors that face international competition and the consequent threat that the job could move abroad (the sectors with the highest risk of low pay are hotels and restaurants and retail and wholesale, while 23 per cent of workers earning less than £7 per hour work in the public sector).[103]

A more pertinent objection is that, given the dire state of the economy, with a huge surplus of labour to demand, now is not the right time to be raising the cost of giving someone a job. Doing so might drive employers to seek to avoid a higher minimum wage illegally. Already it is thought that about 300,000 workers are paid below the national minimum wage, though this is likely to be an underestimate, as those working informally may not show up in surveys.[104] Therefore introducing a living wage is much more feasible when the economy returns to growth. Furthermore, at present, there is scant research on the macro-economic impact of implementing a mandatory national minimum wage of anything approaching what is required to meet the hourly minimum income standard. This is a direction for further research.

These arguments are rehearsed in detail elsewhere.[105] However, whatever the merits of a mandatory living wage, raising the minimum wage is a separate question from whether or not to cut taxes at the bottom end of the income spectrum. The two are not exclusive, they are complementary. Taken together they would have a major impact on raising the income of those in work earning less than the minimum income standard, but of the two, cutting taxes is more feasible over the mid-term. The progressive Conservatism Project at Demos and others have already argued that a living wage could contribute substantially to improving the lives of those in low-paid work.[106] However, this paper focuses on the potential of other policy measures to augment a living wage: policy makers can help low paid workers now, by cutting the burden of government taxation.

Cut indirect taxation or main rates of income taxation?

A further option would be to cut indirect taxes, most obviously VAT. VAT is regressive, distortionary and obfuscatory. But it is not the first priority to cut. Although cutting indirect taxation is superficially attractive, in practice a cut in VAT would not be particularly focused on the poorest. Poorer consumers spend more of their income on products exempt from VAT, such as food. And though indirect tax is regressive, it is also paid by the rich. Moreover, a deflationary cut in VAT could destabilise the macro-economy at this fragile time, and in any case may not be passed onto consumers and simply be retained in higher company profits and hence larger company dividends to shareholders, not rewards to society as a whole, particularly those without assets. Moreover, making goods cheaper incentivises spending. A cut in VAT only benefits those who spend freely. It does not give the option of paying that income into savings or paying off debts. And cutting VAT does nothing to strengthen the connection between effort and reward. Therefore for progressive Conservatives it is not the best solution.

Finally, the basic rate or higher rate of tax could be cut. However, these ideas are rejected as both would be expensive while doing little or nothing to help workers falling below the minimum income standard.

Raise the personal allowance

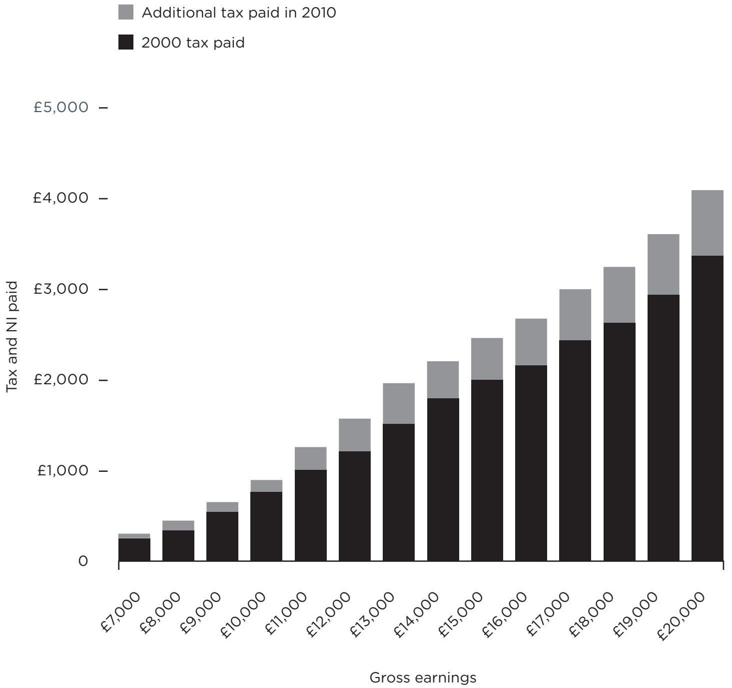
A final alternative is to cut tax for those earning least. New Demos analysis of figures provided by Dr Patrick Nolan proves that the tax burden on workers has risen substantially over the past decade.[107] Individuals earning £12,000 pay £551 more Income Tax and national insurance (in wage-adjusted terms) than they did ten years ago. A person on the median earnings of £25,800 pays £1,625 more than they did ten years ago (figure 10).

As a proportion of earnings, these changes are stark, though of course the net position after tax credits is different. Someone earning the median earnings used to pay 17 per cent of their income in tax. They now pay 24 per cent. Workers earning approximately the minimum wage full time pay 15 per cent of their earnings in Income Tax and national insurance, not 10 per cent as they did in 2000 (figure 11).

However, in percentage terms, the increase in Income Tax and national insurance over the last decade has been most severe for the poorest workers (figure 12). Although all earnings have been hit by increases of over a third in the size of their Income Tax and National Insurance burden, *people on low earnings under £13,000 have been worst hit. Someone on £14,000 has seen an equivalent increase in the size of their burden as someone on £200,000.* Those who have been spared most are actually mid-level earners earning around £25,000.

Given these very rapid increases in tax paid over the last ten years, establishing the principle that workers should only pay

Figure 10 **Amount paid in tax and employee national insurance contributions in 2000/01 and 2009/10, wage-adjusted (£)**

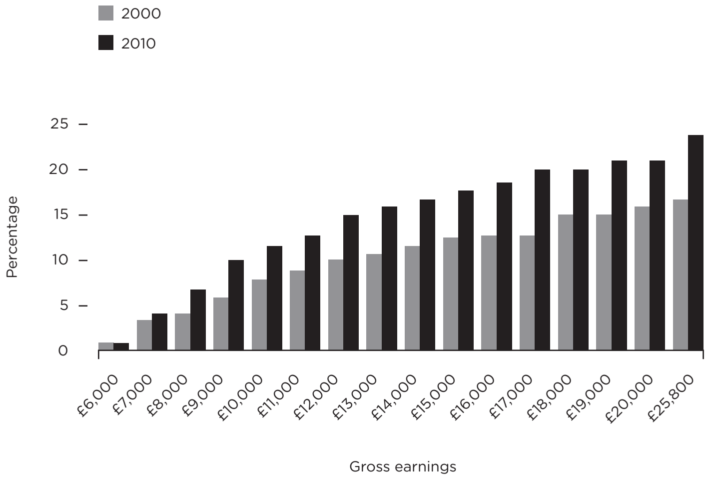


Source: Demos analysis of figures extrapolated from the tax calculators used in Nolan, *Reality Check*.

Note: These figures are in cash terms. They include Income Taxes and national insurance contributions by the employee. They exclude employer contributions and/or tax credits. Nolan makes the assumption that the income is subject to annual wage growth of 3.5 per cent.

tax and national insurance on their earnings if they have already reached the minimum income standard is the best fit to meeting the criteria laid out at the start of the chapter.

Figure 11 **The proportion of one's earnings taken in income tax and national insurance in 2000/01 and 2009/10**



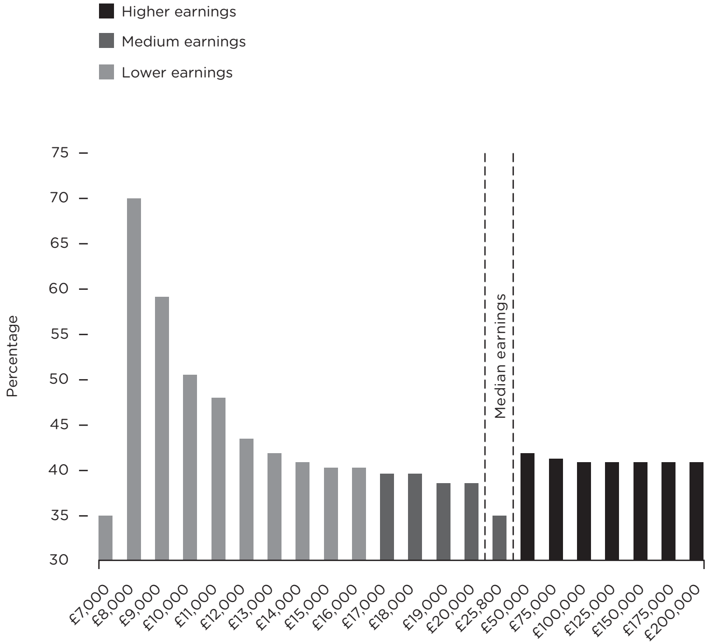
Source: Demos analysis of figures extrapolated from the tax calculators used in Nolan, *Reality Check*.

Note: These figures are in cash terms. They include Income Taxes and national insurance contributions by the employee. They exclude employer contributions and/or tax credits. Nolan makes the assumption that the income is subject to annual wage growth of 3.5 per cent.

In the first place, taking the poorest in work out of Income Tax and national insurance entirely is extremely simple, both to administer and to understand.

Second, removing all tax for those on low earnings provides a crystal clear connection between the value of the hours you put in and the wages you take home. To fix the broken society policy must foster a culture of possibility, self-reliance and responsibility. Helping people to reach the minimum income standard is an essential part of that culture. But it must be done by hard work and fair reward, not taking from one demographic to prop up another. Progressive Conservatives do not believe

Figure 12 **Change in size of the tax and national insurance burden for high, low and medium income earners, 2000/01 — 2009/10**

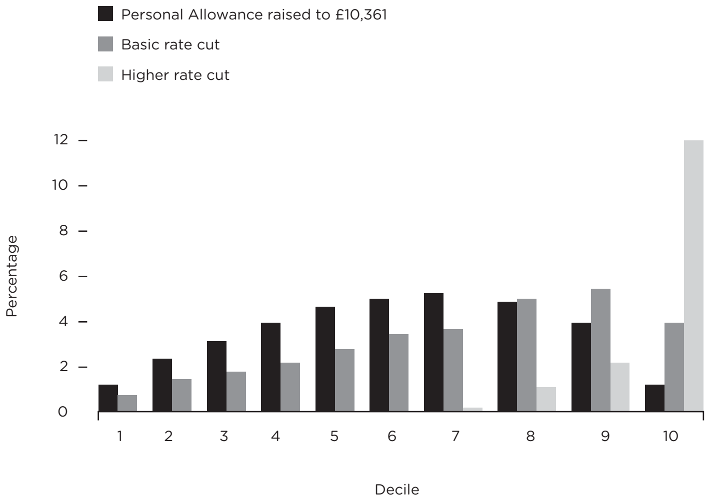


Source: Demos analysis of figures extrapolated from the tax calculators used in Nolan, *Reality Check*. Note, the new 50 per cent tax band on higher incomes will alter this profile from 2010 onwards.

everyone is entitled to reach the minimum income standard regardless of their behaviour. This is not a hand-out. To get the benefit of this measure you have to work.[108] As Conservatives we believe that reform needs to avoid entrenching dependence through state hand-outs and instead find ways to help people help themselves.

Third, it has high impact, providing direct relief to the poorest workers. Although the benefit does not only accrue to the poorest in work, reform like this is much more progressive

Figure 13 **The distributional effects of spending £26 billion by taxing low, middle or high earners**



Source: Demos analysis.

than a tax cut for higher rate taxpayers, as Nigel Lawson and Geoffrey Howe implemented in the 1980s, or the basic rate tax cut Gordon Brown chose to exchange for abolishing the 10 pence tax rate when lowering the basic rate from 22 per cent to 20 per cent in 2007. As demonstrated below, raising the personal allowance to £10,361 (with an accompanying adjustment to higher rate threshold to neutralise the gain for higher rate taxpayers) costs £26 billion. For the same cost, the basic rate of tax could be cut from 20 per cent to 14.5 per cent; or the higher rate of tax could be lowered to 20 per cent – the same as the current basic rate, creating a so-called 'flat tax' system.[109] Measured against these options, cutting tax at the bottom is sharply more progressive. A comparison of the impact of these options is shown in figure 13.

Table 5 **Summary of reform options**

Option for reform	Strong message?	Major impact?	Simple?	Relatively affordable?	Encourages self-reliance?
Increased tax credits		✔		✔	
A living wage			✔		✔
Cut VAT			✔		
Reduce headline rates of tax	✔		✔		✔
Raise personal allowance	✔	✔	✔		✔

Fourth, cutting tax at the bottom reduces the worrying reliance of so many workers on state top-ups for a large proportion of their income. Even for those in work, unlike tax credits this measure is not a giveaway. Raising the Income Tax and national insurance threshold to the minimum income standard does not require the state to redistribute from one person to another. It is merely allowing people to keep enough of what they earn to meet a minimum democratically agreed level of income that enables them to support themselves to participate, before being asked to pay towards the broader cost of society.

Finally, cutting tax at the bottom may also have knock-on benefits by helping stimulate the recovery. Making work pay could save the taxpayer millions of pounds in unemployment benefit. The cost of the measure will be partially offset by the drag-in effect of higher take-home wages on labour market participation. When work pays more, unemployed people are more likely to choose work over benefits. Obviously this effect is weaker in a recession, when there are more people looking for work than jobs, but this is a long-term measure. As the economy returns to growth this drag-in to the labour market could make a substantial impact on structural long-term unemployment. Moreover we know that work has positive effects of mental health and well-being. People in work are less likely to be alcoholic, addicted or depressed, so one might anticipate further knock-on benefits to businesses, public services and public finances. And higher take-home pay will also disproportionately benefit migrants, women and younger workers, who are all over-represented in low paid jobs,[110] and may also have additional productivity benefits.[111]

In addition, quite apart from the moral case for action, raising the threshold would provide a very effective fiscal stimulus for local economies in a time of sluggish macro-economic demand. Poorer people have a much higher propensity to spend locally than the wealthy, so any additional income is likely to go straight to struggling firms on the local high street, not into speculative housing bubbles, overseas investments or complex financial products. A recent study by the Federal Reserve Bank of Chicago confirmed that low-paid American workers given a higher take-home income spent the whole of that increase in the local economy.[112]

Table 5 summarises the pros and cons of the five options.

4 Recommendations

If the new government is serious about tackling social justice and building a Big Society, it should make boosting incomes below the minimum income standard as much a priority as localisation or school reform. The way to do this is to cut tax on low earners. *If it were not for tax, most single working people working full time would meet the minimum income standard without further outside assistance.*

How the new threshold would work

A single person needs £11,489 a year net in order to afford the household budget calculated by the minimum income standard research. But at present, such a person needs to actually earn £13,859 a year before tax to take this net figure home because, even on these low earnings, they pay £1,477 and £894 in tax and national insurance respectively (table 6). Someone earning this much pre-tax is not eligible for tax credits.

Table 6 **Earnings required to meet the minimum income standard for a single person without children**

Pre-tax earnings…	minus income tax…	and national insurance…	… achieves the minimum income standard
£13,859	–£1,477	–£894	= £11,489

This implies an hourly wage of £7.09, yet this is 18 per cent more than the minimum wage, out of the reach of many low-paid workers.[113]

Without tax, but still paying national insurance at the present level, and helped by tax credits, a single working adult aged 25 or over without children could meet the minimum income standard on £11,378 a year, *equivalent to an hourly wage of £5.82 an hour* (table 7). Significantly, this is just 2 pence above the present minimum wage.

Table 7 **Earnings required to meet the minimum income standard for a single person without children if tax is not paid, but national insurance is paid**

Pre-tax earnings...	augmented by tax credits...	if no tax due...	after national insurance...	... achieves the minimum income standard
£11,378	+ £732	– £0	– £621	= £11,489

Indeed on the principle of not taxing a person's effort until they have had a chance to lift themselves out of poverty, national insurance contributions should also be removed for those earning under the minimum income standard for a single earner without children.

Without national insurance to burden them, everyone[114] *would be able to meet the minimum income standard for themselves*[115] *by earning just £10,361, as illustrated in table 8.*[116]

Therefore to help more people reach the minimum income standard, we propose that the new government should take those on very low wages out of Income Tax and national insurance entirely by raising the Income Tax and national insurance threshold to £10,361[117] *– the salary an individual is required to earn before tax credits to support him or herself to the minimum income standard of £11,489.*[118] This is demonstrated graphically in figures 14–16.

£10,361 is not the minimum income standard for all family types. It is the amount a single working person over age 25, living on their own, with no dependants, requires to meet the minimum income standard. This would ensure that all full-time

Table 8 **Earnings required to meet the minimum income standard for a single person without children if tax and national insurance requirements are removed**

Gross earnings…	minus no income tax or national insurance…	helped by working tax credit…	… achieves the minimum income standard
£10,361	– £0	+ £1,128	= £11,489

single workers[119] could provide for themselves to the minimum income standard and would bring many other household types much closer to it.

Figure 14 shows how a single person can meet the minimum income standard in the current system: they need £11,500 net, but must earn over £2,000 more in order to take home that amount.

Adding in working tax credit does not help a single earner reach the minimum income standard at present, because you do not get it if you earn about £13,250 (figure 15).

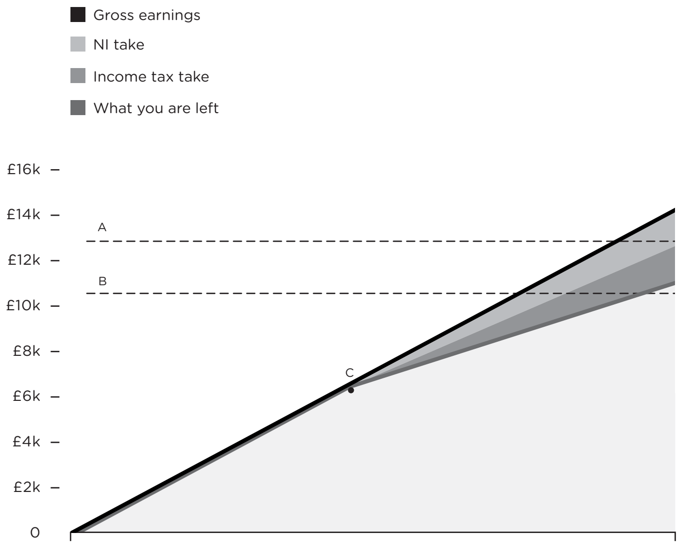
Setting the tax and national insurance thresholds at £10,361 would allow someone who earns exactly that much to end up with their net requirement of £11,489. Such a person is allowed to keep all their earnings, and would also qualify for a working tax credit. The tax credit payment then makes up the difference between what this person earns and what they need (figure 16).

The impact on minimum wage earners

Raising the threshold would make it almost £2,500 easier for a single person on the minimum wage without children to reach the minimum income standard. If they were paid year-round, working 37.5 hours a week (the standard assumption used by people converting a minimum wage into a full-time annual salary), they would earn £11,341 on the present minimum wage of £5.80, short of the minimum income standard by just 1.56 per cent.[120] Tax credits would step in to take this person comfortably over the minimum income standard.

Figure 14 **How a single person can meet the minimum income standard: the current system**

The current system: you need £11,500 net, but must earn over £2,000 more in order to take home that amount



A = MIS earnings requirements = £13,859

B = MIS take-home requirements = £11,489

C = Start paying tax here, well before MIS

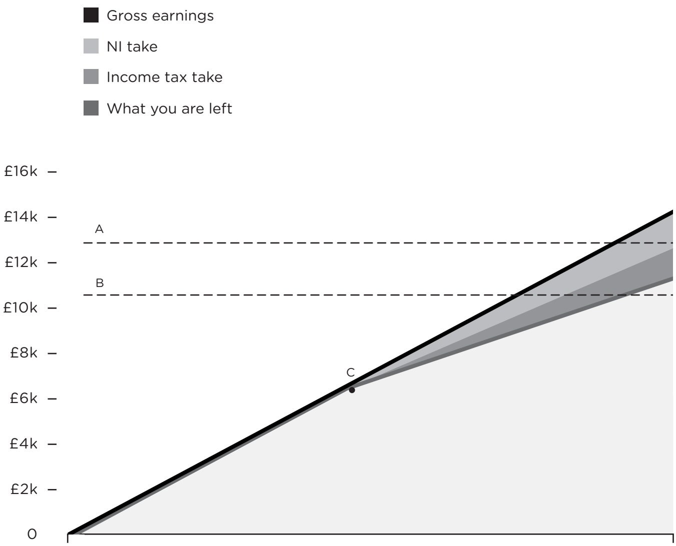
Source: Demos analysis.

Comparing this recommendation with the Liberal Democrat and Coalition proposals

Superficially, raising the threshold to £10,361 only marginally more generous than the Liberal Democrat's pre-election pledge to raise the personal allowance to £10,000.[121] Nick Clegg made fair taxation a centrepiece of the Liberal Democrat's 2010 election message and the Chancellor began to move towards this

Figure 15 **How a single person can meet the minimum income standard: current system, including tax credits**

Adding in Working Tax Credit does not help you reach MIS at present, because you don't get it if you earn above £13,250



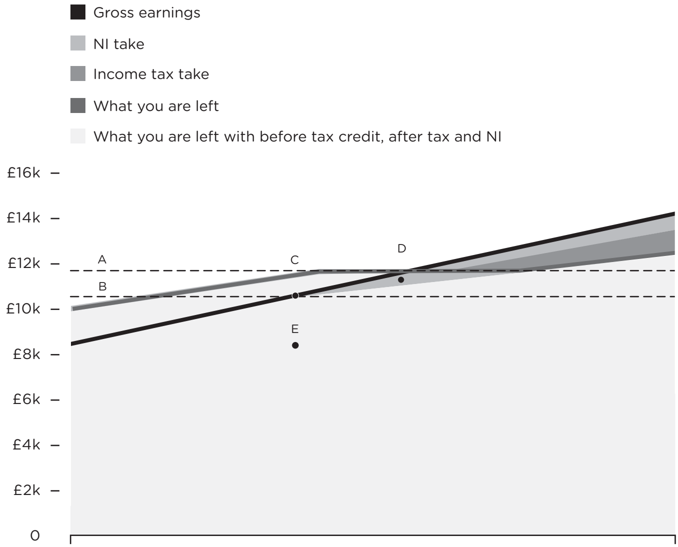
Source: Demos analysis.

figure in June's budget, raising the personal allowance by £1000 to £7,475.

But although it is excellent to see the government raising the personal allowance, our recommendation has a much bigger impact than the Coalition's proposal. *Our recommendation keeps £1,288 in the pockets of anyone earning £10,361 or more – 83 per cent more than the government's proposal, which allows workers to keep only £705 more than at present.*

This is because our recommendations include cutting national insurance contributions (11 per cent of gross income

Figure 16 **How changing the tax and national insurance threshold makes it easier for a single earner to reach the minimum income standard**



A = MIS earnings requirements = £11,489
B = MIS take-home requirements = £10,361
C = New tax allowance (£10,361) – almost £4,000 higher than at present
D = Here, you both pay in tax & NI and receive back tax credits
E = Zero income tax and national insurance paid on earnings under £10,361

Source: Demos analysis.

before tax, rising soon to 12 per cent) as well as Income Tax, which the Coalition policy does not. Indeed, table 9 shows that our recommendations would have almost double the impact of the Liberal Democrat proposals for a single earner working full time on the minimum wage.

Moreover, although the Liberal Democrat £10,000 threshold figure was neat, it is not based on any clear rationale. *In time, it too will be subject to the same fiscal drag that has eroded the current personal allowance.* Our recommendation eliminates fiscal

Table 9 **Comparison of the progressive Conservative recommendation with Liberal Democrat proposals**

Proposal	Status quo £	Liberal Democrat proposals £	Under our recommend-ations £
Gross annual income on minimum wage (full-time)	11,310	11,310	11,310
Tax			
Personal allowance	6,475	10,000	10,361
Taxable income	4,835	1,310	949
Tax due	967	262	190
National insurance			
NI threshold	5,720	5,720	10,361
NI susceptible income	5,590	5,590	949
National insurance contribution	615	615	104
Total deductions	1,581.90	876.90	294.19
Difference in deductions to present system as per cent	0%	44.6%	81.4%
Take-home income	9,728	10,433	11,016
Cash improvement on status quo	-	705	1,288
Per cent improvement in income over status quo	0%	7.2%	13.2%

Source: Demos analysis of HMRC figures.

drag because the threshold is linked to a national minimum standard set and agreed by the public.

Moreover, cutting the burden of the state is fundamentally conservative. As Norman Tebbit has argued, it is wrong and counterproductive to tax people into a situation where they struggle to participate in society, and by extension in democracy.[122] So this issue should not be seen as a concession to the centre-left. Conservatives in government and without should argue strongly for the government to truly tackle the burden of the state on low-earners, but raising not just the Income Tax but the national insurance allowances too.

Impact: how many people would this measure help?

New analysis for this report gives the most accurate ever understanding of the numbers of people living below the minimum income standard in Britain today. Raising the threshold to the minimum income standard for a single person takes 700,000 adults and 580,000 children from under the minimum income standard for their demographic to over it, and raises millions of families closer to the minimum income standard. *This represents a 29.4 per cent drop in the number of working families below the minimum income standard and a 39.6 per cent drop in the number of single working adults* under the minimum income standard (since not all work full time). See table 10 and figures 17 and 18.

However, counting the number of people who cross the minimum income standard threshold does not tell the whole story. Figure 19 shows the numbers of working age adults on family incomes in the range lying between 50 per cent below the minimum income standard and 50 per cent above the minimum income standard, before and after the reform. It shows that the distribution of net incomes shifts significantly upwards as a result of the reform.

The tax credit system is not affected by raising the tax allowance, except in so far as it may raise disposable incomes and therefore reduce tax credit payments somewhat. These results include the impact of tax credits on disposable income and hence

Source: Demos analysis of the Family Resources Survey; see annex 3.
Note: the figure of £5,225 was the personal allowance Income Tax threshold for Family Resources Survey 2007–08. These figures take account of four demographics only, not the full range of demographics assessed by the original Joseph Rowntree Foundation research (couples with three children for example). They are therefore underestimates of the full numbers that would be affected by reform.

Table 10 **The impact of raising the threshold of the number of people in work living below the minimum income standard**

	Total earning above £5,225	Under MIS: 2007-08 system		Under MIS: reformed system		

Number of adults with gross employment income above £5,225 living in families with BHC income below the MIS level, before and after proposed reform

Adults Family type	Number of adults (m)	Number of adults (m)	% of total	Number of adults (m)	% of total	% decrease of those under MIS
Single, no children	6.4	1.06	16.60	0.64	10.00	39.62
Single with children	0.84	0.16	19.00	0.13	15.50	18.75
Couple, no children	9.26	0.5	5.40	0.4	4.30	20.00
Couple with children	7.71	0.84	10.90	0.69	8.90	17.86
Total	24.21	2.56	10.60	1.86	7.70	27.34

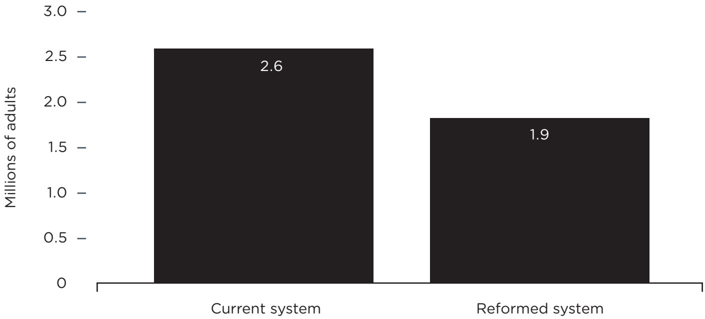
Number of children living in families with at least one adult with gross employment income above £5,225 and BHC income below the MIS level, before and after proposed reform

Children Family type	Number of children (m)	Number of children (m)	% of total	Number of children (m)	% of total	% decrease of those under MIS
Single with children	1.23	0.27	22.00	0.22	17.90	18.52%
Couple with children	6.63	0.94	14.20	0.8	12.10	14.89%
Total	7.86	1.21	15.40	1.02	13.00	15.70%

Number of families with at least one adult with gross employment income above £5,225 and BHC income below the MIS level, before and after proposed reform

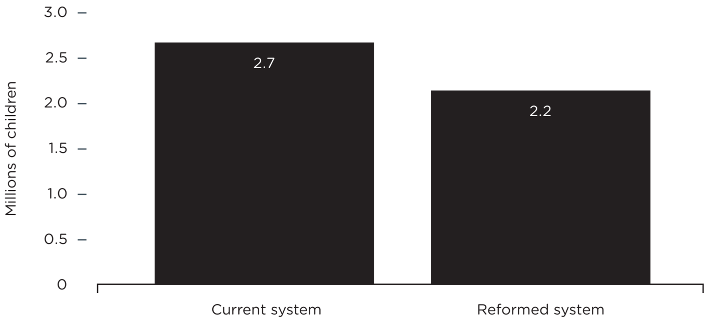
Families Family type	Number of families (m)	Number of families (m)	% of total	Number of families (m)	% of total	% decrease of those under MIS
Single, no children	6.4	1.06	16.60	0.64	10.00	39.62%
Single with children	0.84	0.16	19.00	0.13	15.50	18.75%
Couple, no children	4.9	0.33	6.70	0.27	5.50	18.18%
Couple with children	3.86	0.42	10.90	0.35	9.10	16.67%
Total	16	1.97	12.30	1.39	8.70	29.44%

Figure 17 **The impact of reform on the numbers of working adults falling below the minimum income standard**



Source: Demos analysis of Family Resources Survey.

Figure 18 **The impact of reform on the number of children of lone working parents under the minimum income standard**

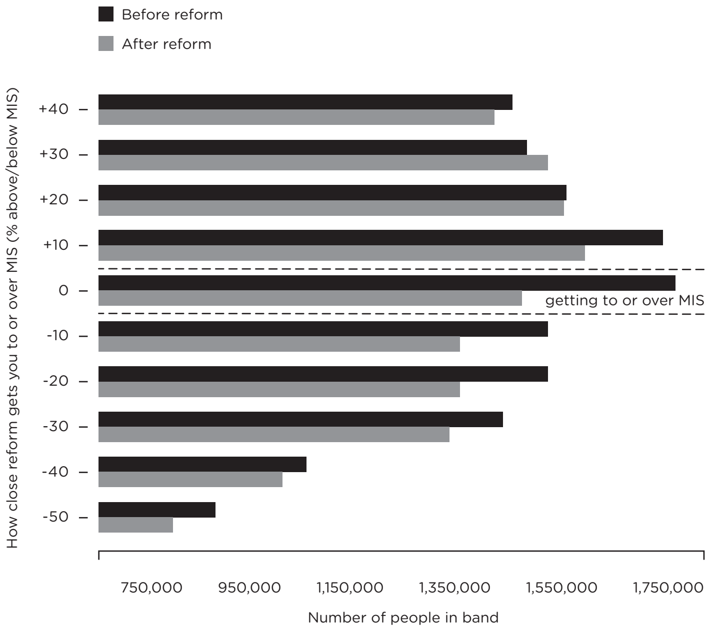


Source: Demos analysis of Family Resources Survey.

the numbers reaching the minimum income standard. Long term, if this policy was adopted there would be a natural reduction in tax credit dependency in the UK.

Note that these figures are based on the minimum income standard needed for each demographic (which can be over

Figure 19 **The impact of reform on getting net incomes closer to the minimum income standard, if not over it, before and after raising allowances**



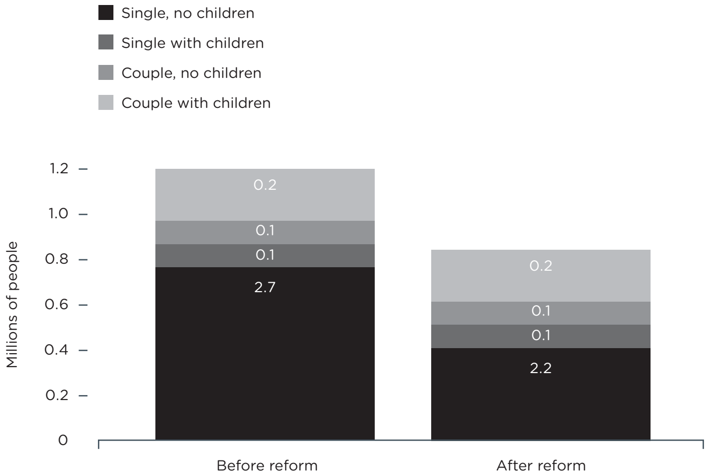
Source: Demos analysis of Family Resources Survey.

£27,000 for couples with children), not just the numbers over the minimum income standard for a single person, which is where the new tax threshold would be set.[123] So for comparison, it is worth noting that the impact of numbers of people getting over the minimum income standard for a single person from all demographics would be much higher.

Table 11 **The impact of raising the threshold on the numbers of people in work living in the twilight zone between the breadline and the minimum income standard**

	Total earning above £5,225	Under MIS: 2007-08 system		Under MIS: reformed system		
Twilight zone for adults with gross employment income above £5,225 living in families						
Adults						
Family type	Number of adults (m)	Number of adults (m)	% of total	Number of adults (m)	% of total	% decrease of those under MIS
Single, no children	0	0.76	11.90	0.4	6.20	47.37%
Single with children	0	0.1	11.90	0.09	10.70	10.00%
Couple, no children	0	0.2	2.20	0.16	1.70	20.00%
Couple with children	0	0.42	5.50	0.35	4.50	16.67%
Total	0	1.48	6.10	1	4.10	32.43
Twilight zone for children living in families with at least one adult						
Children						
Family type	Number of children (m)	Number of children (m)	% of total	Number of children (m)	% of total	% decrease of those under MIS
Single with children	0	0.17	13.90	0.14	11.40	17.65%
Couple with children	0	0.47	7.10	0.41	6.20	12.77%
Total	0	0.64	8.10	0.55	7.00	14.06%
Twilight zone for families with at least one adult						
Families						
Family type	Number of families (m)	Number of families (m)	% of total	Number of families (m)	% of total	% decrease of those under MIS
Single, no children	0	0.76	11.90	0.4	6.20	47.37%
Single with children	0.1	11.90	0.09	10.70	10.00%	
Couple, no children	0	0.13	2.60	0.11	2.20	15.38%
Couple with children	0.21	5.50	0.17	4.40	19.05%	
Total	0	1.2	7.50	0.77	4.80	35.83%

Figure 20 **The impact on working families in the 'twilight' zone before and after reform**



Source: Demos analysis of Family Resources Survey.

The impact on those living between minimum income standard and the breadline

The reductions in the number of working people living in the 'twilight zone' are also substantial: *near halving of the numbers of single adults between the poverty line and the minimum income standard; and a 35.8 per cent reduction for working families as a whole.* See table 11 and figure 20.

The impact on poverty itself

This reform would also have a big impact on those in work below the breadline (below 60 per cent of median income), *cutting income poverty among working adults by 20.4 per cent and*

Source: Demos analysis of Family Resources Survey.

Note: Figures for the impact of the total population – those in work and out of work – are included in annex 4.

Table 12 **The impact of raising the threshold on the numbers of people in working poverty**

	Total earning above £5,225	Under MIS: 2007-08 system		Under MIS: reformed system		
Number of adults with gross employment income above £5,225 living in families with BHJC income below 60% median, before and after proposed reform						
Adults						
Family type	Number of adults (m)	Number of adults (m)	% of total	Number of adults (m)	% of total	% decrease of those under MIS
Single, no children	6.4	0.3	4.70	0.24	3.80	20.00%
Single with children	0.84	0.06	7.10	0.04	4.80	33.33%
Couple, no children	9.26	0.3	3.20	0.24	2.60	20.00%
Couple with children	7.71	0.42	5.40	0.34	4.40	19.05%
Total	24.21	1.08	4.50	0.86	3.60	20.37%
Number of children in families with at least one adult with gross employment income above £5,225 and BHC income below 60% median, before and after proposed reform						
Children						
Family type	Number of children (m)	Number of children (m)	% of total	Number of children (m)	% of total	% decrease of those under MIS
Single with children	1.23	0.1	8.10	0.08	6.50	20.00%
Couple with children	6.63	0.47	7.10	0.39	5.90	17.02%
Total	7.86	0.57	7.30	0.47	6.00	17.54%
Number of families with at least one adult with gross employment income above £5,225 and BHC income below 60% median, before and after proposed reform						
Families						
Family type	Number of families (m)	Number of families (m)	% of total	Number of families (m)	% of total	% decrease of those under MIS
Single, no children	6.4	0.3	4.70	0.24	3.80	20.00%
Single with children	0.84	0.06	7.10	0.04	4.80	33.33%
Couple, no children	4.9	0.2	4.10	0.16	3.30	20.00%
Couple with children	3.86	0.21	5.40	0.18	4.70	14.29%
Total	16	0.77	4.80	0.62	3.90	19.48%

Source: Demos analysis of the Family Resources Survey; see annex 3.

reducing the number of working single parent families in poverty by a third (table 12).

Furthermore, raising the threshold would do much to support younger workers, who at present can earn well below the minimum income standard because of lower levels of minimum wage for those aged 21 and under.

Supporting other family types

The minimum income standard differs for pensioners, couples, families and so on. The original Joseph Rowntree research focused on 15 demographic groups. The figure of £10,361 is the minimum income standard for one group only: single working aged people with no dependants.

Therefore there is still a role for tax credits to support other family types. An ideal reform would offer differing allowances for each, but such an attempt would entail a massive reorganisation of the entire British taxation administration, which is outside the scope of this research. Raising the threshold to £10,361 is a start, which can be made now and be the basis for further reform in the future.

We can see the effect of this reform by returning to our hypothetical case studies.

Vicky

Vicky, living on her own, earning £6 an hour in a shoe shop, is £17 short of the minimum income standard every week, an eighth of her total budget. As a result she has either foregone some physical necessities or is unable to participate socially and culturally in society, for example by scarcely ever spending money on going out.

However, if the tax and national insurance thresholds rose to £10,361, Vicky would only have to pay about £8, rather than £33, a week in tax and national insurance. The £25 she would gain each week would be enough to meet a minimum budget, and she would have about £8 left to put aside for rainy day savings or the occasional extra treat.

Lindsey

Lindsey is a working single parent from Belfast. Despite improvements to benefits for lone parents, she is still £28 a week short of what she needs for a minimum acceptable standard of living. Rises in tax credits have enabled lone parents like Lindsey working part time on low wages to be much better off than previously, and now provide a clearer incentive to work, but can still trap them on incomes that are not quite enough. She wants to work more, but tax and national insurance benefit withdrawals create an effective tax rate of 70 pence for every pound she would earn.

But if the tax threshold were raised to £10,361, Lindsey would have £17 a week more at her present salary, and a further £12 a week more if she worked more hours to raise her earnings by £1,000 a year, bringing her above the minimum acceptable living standard. Raising tax thresholds would make it more feasible for single mums like Lindsey to make working worthwhile.

Tony and June

Tony and June, who are struggling on June's salary since Tony lost his job at the car factory, are £22 a week short of what they need for a minimum standard of living because June pays £82 a week in tax and national insurance.

If the tax and national insurance thresholds were raised to £10,361 a year, this figure would reduce to £57, giving the couple a welcome £25 a week more, enabling them to reach the minimum income standard and put £3 a week towards their retirement.

Barry and Jill

Barry and Jill are both in work to help raise their two children Nicola (13) and Lee (9). At present they fall £50 below the minimum income standard every week. They can still put food on the table, but only by stopping taking Lee to Cubs (£7 a week) and cutting out the one night a fortnight for the occasional trip to the cinema that they used to try to spend together, to pay their £55 a week tax and national insurance bill.

If the tax and national insurance thresholds were raised to £10,361, this family would pay only £8 rather than £55 a week in tax and national insurance. This would raise their net income to £557 a week, within £3 of the minimum income standard they require, rather than falling £50 short. Money would still be tight, but by being careful they would still be able to give their children a chance to mix with others, and themselves a night off together once a month.

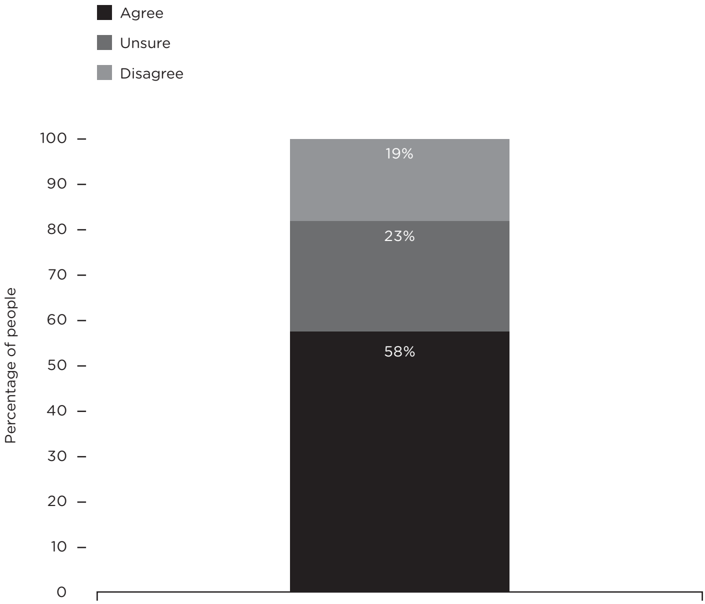
Public opinion supports action to relieve the burden on the poorest in work

Public opinion is broadly in favour of measures to relieve the burden of taxation on people on low incomes. Not taxing people until they have earned enough to support themselves as members of society seems instinctively fair, and surveys of public attitudes suggest that many people support this assertion. Evidence is not conclusive, but recent work by Horton and Bamfield demonstrated that there is widespread public support for this kind of measure:[124] More than half (58 per cent) of those they surveyed agreed that government should take action to close the gap between rich and poor, while 59 per cent agreed that 'poor people at the bottom have a really tough time overall, because they work hard but without the rewards of the rich or the middle, and with more stress and anxiety than other groups' (figure 21).[125]

When participants were shown evidence of the combined effects of direct and indirect taxes on gross household incomes by income quintile, most were shocked to find that the overall impact of the tax system was regressive, with taxes taking a higher percentage of gross income for the bottom quintile than the top one (a situation variously described as 'impossible', 'unbelievable' and 'crazy').[126]

Horton and Bamfield's report demonstrated there was support for measures designed to help people to help themselves such as the measure proposed in this paper. The study found that 'participants… preferred arguments for greater equality framed in terms of fairer rewards for effort and contribution',

Figure 21 **Proportion of people who agree with statement: 'Government should take action through tax and benefits to reduce the gap in incomes between the richest and the poorest'**



Source: Bamfield and Horton, *Understanding Attitudes to Tackling Economic Inequality.*

and that 'many participants… showed strong support for a social vision based upon improving quality of life for everyone'.

When asked how they would do this, most participants said they would reduce the burden of taxation at the lower end of the income spectrum, perhaps even to zero, and increase it at the top end.[127] The research quotes one typical exchange:

Question: *Do you think Angela [earning £8,000] should pay any taxes?*

Participant 1: *No, I was gonna say, how can she, there'll be nothing left!... I think Angela's paying too much.*
Participant 2: *I don't think Angela should be paying tax on her salary.*

Overall, the study found that not only was there widespread support for progressive taxation, but that participants 'routinely expressed sympathy that those on low incomes might have to pay any tax at all'.[128]

5 The fiscal context: sharing the proceeds of recovery

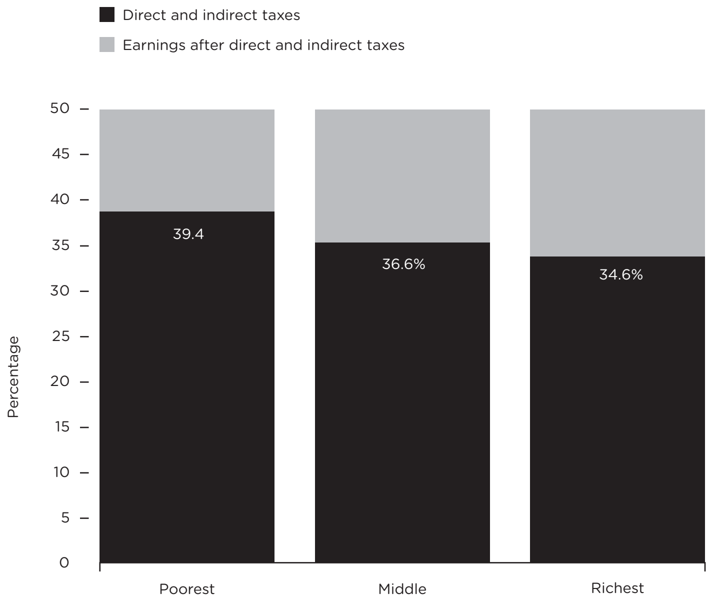
Before the recession some politicians spoke of 'sharing the proceeds of growth'. Our recommendation policy provides a mechanism for sharing the proceeds of recovery.

Although hard to imagine now, within the next few years the economy will return substantial growth. If we return to moderate growth of just 2 per cent, tax revenues will increase by around the cost of this reform every year within a matter of years, and much sooner if the Treasury's forecast of 3–3.5 per cent growth in 2011 in the March 2010 budget was correct.[129] However, beyond that, there will come a time when the economy is growing fast enough for a future chancellor to have some scope to choose where to invest to secure the recovery and create a just reward for hard work. A tax cut before the end of this Parliament is not inconceivable – indeed it is the premise of the present government's commitment to raising the threshold.

If Conservative politicians still believe what they have long advocated, that over the long term government's share of spending in the economy should be returned from 43 per cent to 40 per cent, then cutting the threshold of Income Tax is a very good way to return this wealth to the economy, since the annual revenue foregone by raising the tax threshold to the minimum income standard – £20–26 billion – is almost exactly 3 per cent of GDP.

Our argument here is that if there are to be cuts in personal taxation, they should be made at the bottom, not by cutting the basic or higher rates of tax in a populist move to curry favour in marginal seats. Popular commentary tends to assume that the wealthy bear the brunt of the tax burden, and in absolute terms that is true. But in reality the poorest quintile pays the highest proportion of their income in direct and indirect taxes (figure 22).

Figure 22 **Proportion of gross household[130] income[131] taken by tax[132] for non-retired households, by quintile groups, 2006/7[133]**



Source: Jones, *The Effects of Taxes*.

Indeed, if, as many on the right have long argued, high tax rates are a strong disincentive to effort and enterprise, then surely the disincentive to play a productive part in the economy is now much stronger at the bottom of the income spectrum than any disincentive at the top end. At present people entering work are hit by a double bind: their benefits will fall and their income will be hit by taxation. The City howled at the thought of a 50 per cent tax rate on earnings over £150,000 (which it is worth noting is around six times the average person's earnings). Yet, as a result of this double bind, workers at the other end of the spectrum routinely face crippling marginal rates of up to, and even in excess of, 100 per cent of every pound they earn as they enter the workforce. Although workers would still suffer benefit and tax credit withdrawal, cutting national insurance and Income Tax would reduce this very high rate by making work 31.7 pence more attractive for every pound earned in wages between the current personal allowance and £10,361.[134] Such a measure would complement reform for those out of work recently proposed by the Centre for Social Justice and Policy Exchange.[135] If Mrs Thatcher was in Downing Street today, this is surely where she would focus her ire.

Of course, even with one of the mitigation options outlined below, there remains some deadweight cost for higher income deciles. Raising the tax and national insurance thresholds would help the poorest workers, but it would also mean a tax give away to all workers from paupers up to those paying the higher rate of Income Tax.

However, this is not necessarily a bad thing, since the minimum income standard for couples with children is substantially higher than for a single earner without children: up to £27,000 or more depending on the number of children. So part of what appears to be a deadweight cost may still be helping other family types to reach their minimum income standard.

Moreover, for Conservatives, the issue of deadweight cost is beside the point. Progressive Conservatives assert the taxman is not entitled to loot from all sections of a person's pay packet, regardless of one's earnings. To treat everything people earn as the potential property of the state reinforces a passive, contrary and unconservative mindset in which citizens should be pathetically grateful for what a gracious Exchequer has deigned to permit them to keep. For Conservatives, taxation is not tribute to some distant anthropomorphised state but a willing and necessary agreement between citizens, not with the state, to exchange some of what they earn over and above a bare minimum to create a better society. Tax is the price of civilisation.[136]

Further, this is not a theoretical discussion about creating an unprecedented tax-free threshold *ex nihilo*. A tax-free personal allowance with associated deadweight cost already exists. The current personal allowance of £6,475 already equates to something like £40 billion pounds or more in revenue foregone, compared with a basic rate of tax extended to all earnings down to £0.[137] Although this paper would not advocate such a reform, it would be logically coherent to argue against any tax free allowance at all. *This paper proposes that if we are going to have the tax-free threshold at all, it should be set in a rational place*. For progressive Conservatives, that rational level is the minimum needed to support oneself in society: the minimum income standard.

In fact, raising the threshold is merely returning the tax allowance back to nearer the historical consensus on when one should start to pay towards the cost of society.[138] The first commentator to consider this question was Adam Smith. Smith's concept of tax justice was based on a firmly social conception of needs.[139] In *The Wealth of Nations* he argued that the state should not tax what he termed 'necessaries'. As he explained:

> *By necessaries I understand, not only the commodities which are indispensably necessary for the support of life, but* whatever the custom of the country renders it indecent for creditable people, even of the lowest order, to be without. *A linen shirt, for example, is, strictly speaking, not a necessary of life… But in the present times, through the greater part of Europe, a creditable day-labourer would be ashamed to appear in public without a linen shirt… Custom, in the same manner, has rendered leather shoes a necessary of life in England. The poorest creditable person of either sex would be ashamed to appear in public without them. Under necessaries, therefore, I comprehend, not only those things which nature, but* those things which the established rules of decency have rendered necessary to the lowest rank of people.[140]

Subsequent thinkers followed in Smith's footsteps.[141] In 1799 William Friend argued that tax should not eat into a minimum standard, writing: 'there must be a certain income, which will exactly keep a man, his wife and two children; and if from that income anything is taken away, the family is deprived of necessaries'.[142] Later, in 1852 the Parliamentary Select Committee on the Income and Property Tax heard many witnesses argue for the retention of a subsistence exemption from Income Tax. John Stuart Mill defended the exemption before the Select Committee on the ground that taxing the income needed for minimum subsistence would be too injurious, and equality of sacrifice between taxpayers could not be established without security of that income required for necessities.[143] Although no firm principle was established in the nineteenth century, for people on low incomes this threshold would need to be nearly 100 per cent of most workers' incomes if they were not to starve. Until the twentieth century, Income Tax was supposed to be something for only the rich. The average man paid little or no tax on his wages.

With the development of the welfare state in the early twentieth century, officials sought to set the threshold according to more explicit principles. A Royal Commission on the Income Tax admitted in 1920 that 'the truth is that the exemption limit has never been based on a figure consciously related to any kind of minimum of subsistence'.[144] In their evidence to the Royal Commission on Income Tax in 1919, many witnesses wanted the threshold for direct taxation lifted, although they could not agree by how much. The lowest proposal came from the National Chamber of Trade, but even its representatives agreed that some allowance was justifiable because 'a man with so small an income was already sufficiently taxed through indirect taxes'.[145]

In an effort to formalise the previously unwritten convention on not taxing the subsistence incomes, the Royal Commission delineated two ways of understanding 'subsistence'. The first was an income sufficient only for 'bare subsistence'. This was clearly not a level of living on which anyone could be expected to survive for more than a short time, because the second definition was an income 'large enough to equip and sustain a *healthy and efficient citizen*, not merely to keep him alive'.[146] An early ancestor of today's definition of the minimum income standard as the minimal level required for participation in society, the Commission's clear view was that the tax threshold should be based on this second measure.

According to the leading historian of taxation, 'until the Second World War the Income Tax was not meant to bite working class but only middle class incomes'.[147] The principle of not levying direct tax on incomes that were beyond just bread and water was reiterated by officials after the Second World War.

The 1951–5 Royal Commission on the Taxation of Profits and Income accepted the 1920 definitions, saying:

Any scheme of taxing incomes has to provide an answer to the question whether all incomes are to be taxed, however small; and, if not all incomes, what is to be the standard by which the exemption of the smallest incomes is to be determined... We feel no doubt that the answer should be there should be no Income Tax levied upon any income which is insufficient to provide its owner with what he requires for subsistence... We have not found it necessary... to be precise in outlining what we have in mind by 'subsistence'. Undoubtedly it requires an income larger than the first suggestion [of 'bare subsistence' made in 1920]... what we are thinking of is something that corresponds to the second suggestion.[148]

The 1960s onwards

From the 1960s, however, the principle of a minimum income beyond subsistence exempt from tax began to be eroded. In the 1950s the tax threshold for a two-child family was approximately the same as average male earnings. A decade later it had fallen to only around 70 per cent of average earnings.[149] The reasons for this erosion had nothing to do with principle and all to do with making life easier for administrators in Whitehall. One senior official reported:

[The Revenue's] interest in personal allowances tended to be confined to management and not philosophical issues. We were concerned at the effect that the ever-increasing gap between average wage levels and the Income Tax threshold was having on staff numbers and our capacity to run the system at all. As a generalisation, given that there was money to be given away in any budget and that the Chancellor of the day had decided to apply some or all of it to direct tax, we would urge, for management reasons, that it be devoted to an increase in allowances rather than to a rate reduction. I do not think it would be any truer to say now than it was, say, thirty years ago, that the Revenue has a 'philosophic' view about where the level of tax allowances ought to be.[150]

Another official, Dr J Leonard Nicholson, who had been chief economic adviser to the Department of Health and Social

Security (1968–76) recalled that by the 1960s the Inland Revenue 'never explicitly said to themselves, what would be a sensible level at which to start taxing people?'.[151]

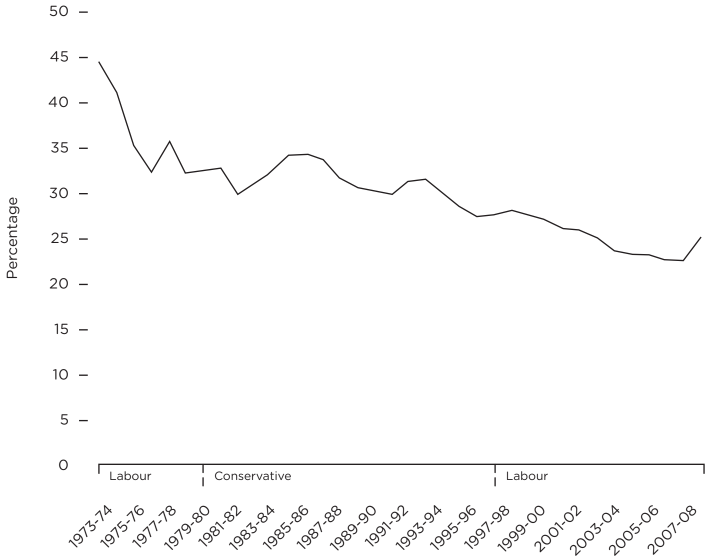
Alarmed by this slide, in 1971 the Conservative government's Cabinet Social Services Committee set up the Treasury-chaired Steering Group for Family Poverty Review to determine the right level to start taxing low earners. The Steering Group rejected the idea of 'cross-over', whereby workers might be on benefits and still pay tax, ruling that 'the gap between the Supplementary Benefit level [then the main form of cash benefit to those on low income, both in and out of work] and the tax threshold has narrowed substantially over recent years… *the tax threshold should always be above the Supplementary Benefit level for everyone*. It would seem extremely difficult to justify the payment of tax by someone who is below the Supplementary Benefit level.'[152]

The 1971 Steering Group was the most recent official body to rule publicly on when people should start to be directly taxed. However, since then, fiscal drag has eroded the real value of this principle to leave a sum impossible to meet the minimum income standard on. The real reason why low earners struggle is that government has allowed the personal tax allowance to fall drastically in the past four decades. *Relative to national income per head, tax allowances have almost halved since the early 1970s* (figure 23).

A consistent data set is not available before the 1970s, but the incomplete data given in table 13 and figure 24 indicates that many more people are now subject to Income Tax than historically was usual. The numbers paying tax have greatly increased decade by decade.

Both parties are guilty here. In the 1970s the Labour government allowed serious erosion by failing to uprate the allowance in line with inflation in a high-inflation era. The subsequent Conservative administration partly remedied this, but as this was a period of rapid real income growth tax allowances did not always keep up, especially in the later years. Under Labour the fiscal drag through inflation-only upratings has continued, with only a short recent blip resulting from the

Figure 23 **How the tax allowance has fallen as a percentage of GDP per capita**



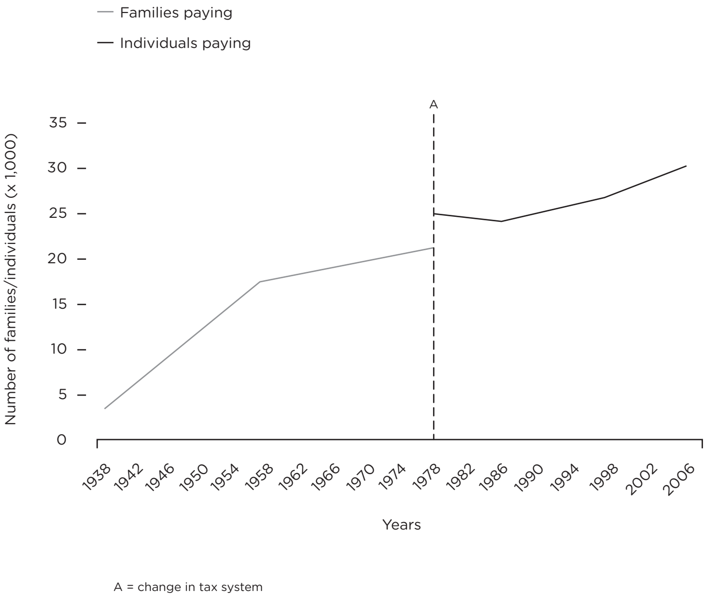
Source: Analysis based on IFS Fiscal Facts dataset.

Table 13 **The increase in the number of people falling into income taxation throughout the twentieth century**

	Number paying tax (thousands)					
	1938	1959	1978	1988	1998	2008
Families	3,800	17,700	21,400			
Individuals			25,500	25,000	26,900	30,600

Source: Demos analysis of IFS datasets.

Figure 24 **The increase in the number of people falling into income taxation throughout the twentieth century (graphical format)**



Source: Demos analysis of IFS datasets.

rise in the personal allowance introduced to compensate for the 10 pence tax rate removal. Our recommendation reasserts the long-standing principle of the right of everyone to earn a basic level of income before the state moves in to siphon any off. It is time to reverse the madness of taxing the poor.

6 Paying for reform

The one criterion this measure does not score highly on is cost. Undoubtedly this reform is expensive. The full cost of raising the threshold for all workers is £31.8 billion, *ceteris paribus*. Clearly, on the face of it, this is a gigantic figure. We do not advocate simply adding to the budget deficit to pay for raising the threshold. The cost of this measure should be made up by raising taxes, efficiencies and innovations or cutting spending elsewhere. Obviously there are a multiplicity of possible ways to make raising the Income Tax threshold revenue-neutral for the public purse, including adjusting the tax credit system; increasing carbon, inheritance or capital gains taxes; increasing the Income Tax bands or rates; or cutting public spending.

These are political decisions outside the scope of this research. This report does not present a prescriptive 'correct' answer about where the additional revenue should come from. Others are better placed to do that and it would distract from the central theme of this paper. *However, it is possible to cut the cost of this reform by up to a third without creating losers.*

Mitigating the cost of reform

This chapter discusses two options to minimise the fiscal impact of this measure on public finances. Rather than make a political judgement about who should be the winners and losers of raising the threshold, the options below explore what can be done within *the principle of benefiting those in need, while leaving no taxpayer worse off than they are at present*. In fact, direct taxes can be raised to ameliorate the fiscal impact of the reform and still leave every worker better off, so long as the tax increases demanded are not bigger than the gain to each worker of having a 60 per cent higher tax free allowance. There are two mutually exclusive ways to achieve this.[153]

Option 1 Eliminate the benefit to higher rate tax payers

Option 1 mitigates the cost of raising the personal allowance by lowering the point at which people begin to pay 40 per cent taxation on their earnings from £43,875 to £39,989 (which equals the current total earnings point where one starts to pay 40 per cent on one's earnings minus the increase in the personal allowance proposed in this report).

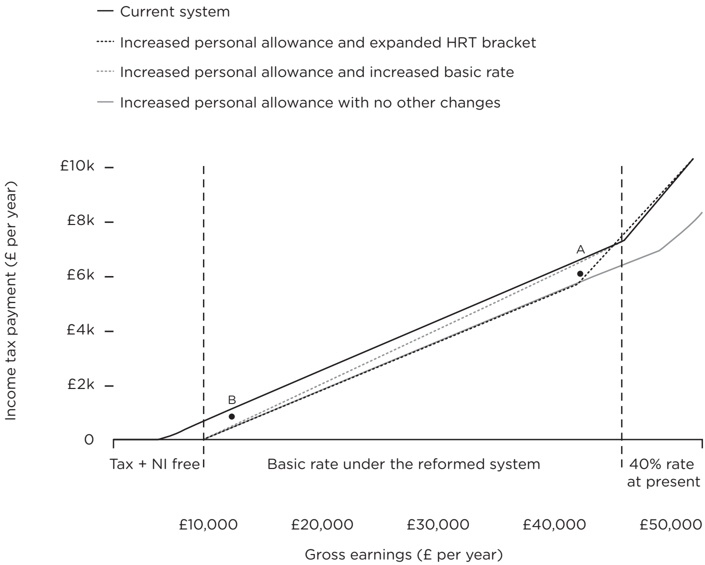
This eliminates any benefit to those who currently pay the higher rate of tax, but does not increase their overall Income Tax bill.

The 40 per cent threshold (measured in terms of total income, not taxable income) only needs to fall by as much as the personal allowance rises to negate our reform's effect for the better off. Every £1 increase in the personal allowance at the lower end of the earnings spectrum means 20 pence of basic rate tax revenue is foregone. Measuring the Higher Rate of Tax in terms of total income, every £1 decrease in the Higher Rate of Tax leads to 20 pence of extra revenue (because the tax rate on that income rises from 20 pence to 40 pence, not 0 pence to 40 pence). Hence the 40 per cent band *in terms of total income* only needs to fall by the same amount as the personal allowance is raised: £10,361 minus £6,475. (If measured *in terms of taxable income*, the 40 per cent band needs to fall by twice that.) Under this option:

- All earners below £10,361 would pay no tax or national insurance at all.
- Everyone earning between £10,361 and £29,628 would get a tax cut of £1,128 each year.
- Everyone earning over £29,628 – approximately the top 40 per cent of earners – would neither gain nor lose from the reform.[154]

This reduces the cost of the reform by 18 per cent to £26.2 billion, making a still sizeable (but much reduced) dent of 4.3 per cent

Figure 25 **Ways to cut the cost of reform without creating any losers**



A = Additional tax cut in option 1: expanded 40 per cent band
B = Tax cut option 2: 22.3 per cent basic rate

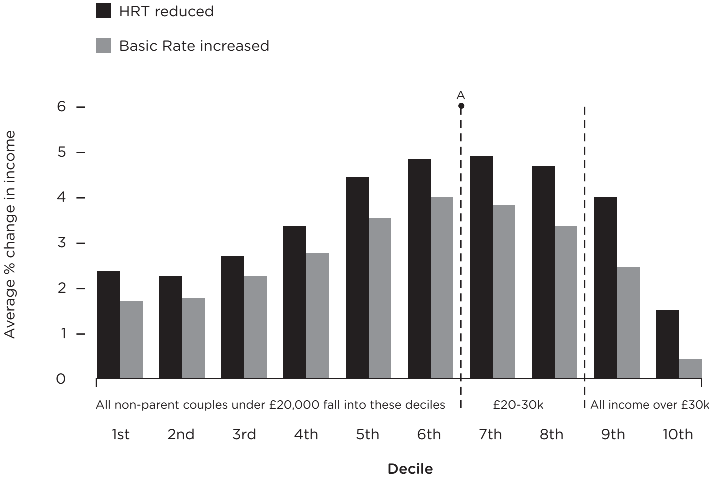
Source: Demos analysis of HMRC figures.

of total tax revenue, or 8.3 per cent of national insurance and Income Tax revenue, *ceteris paribus*.

Option 2 Reduce the gain to basic rate tax payers

Option 2 lowers the cost further by reducing the gain to basic rate taxpayers, by raising the basic rate of tax slightly and leaving the higher rate where it is (imposed on earnings of £43,875 or more). This option costs much less and *cuts tax for all workers*. Basic rate tax payers would be better off, but not as

Figure 26 **The distributional effects of adopting mitigation: option 1 versus option 2**[159]



A = Income here £13,680 for a single person: just under what is currently required to reach MIS

Source: Demos analysis of data from Family Resources Survey using ippr tax and benefit model.

much as under the proposal of option 1. Higher rate tax payers would be slightly better off under this proposal too. Our calculations show that this outcome would be achieved if the basic rate of Income Tax were increased from 20 per cent to 22.3 per cent.[155] *This reform would reduce the cost of raising the tax-free threshold by 36 per cent to £20.5 billion.* So this option is cheaper than option 1, but not as progressive (in the technical economic sense of the word).

Mathematically these two options cannot be combined if no one is to lose out from raising the tax-free allowance – at least not to raise as much revenue as either option in isolation.[156] Obviously if the assumption of not creating losers made here was abandoned, then the measure could be achieved much more

Table 14 **What these deciles mean in practice (equivalised incomes)**

	Annual income (£)	
Decile cut-off	Single, no children	Couple, no children
1st/2nd	4,127	6,159
2nd/3rd	6,177	9,219
3rd/4th	7,831	11,688
4th/5th	9,409	14,043
5th/6th	11,227	16,756
6th/7th	13,680	20,418
7th/8th	16,921	25,255
8th/9th	21,353	31,870
9th/10th	29,377	43,847

Source: Net income decile cut-off points, Family Resources Survey data used for ippr tax-benefit model (2009/10 prices).

easily, since every penny on the basic rate of tax generates several billion pounds worth of additional revenue to the Treasury, *ceteris paribus*.

Figure 25 compares these options graphically with unmitigated ways of raising the personal allowance and to the status quo.[157] For those earning between £6,475 and £10,361 of gross income, both reform systems are identical. For those earning between £10,361 and £43,875, taxpayers pay more tax under option 2 (where basic rate is increased) than under option 1 (where basic rate is held constant and the higher rate threshold lowered). However, in both cases taxpayers are better off than under the present system.

Who benefits most under each option?

Figure 26 shows the distributional effects of both versions of the reform – the version where the higher rate of tax is reduced so that high-Income Taxpayers are no better off, and the version where the basic rate of Income Tax is increased instead. It shows the average percentage change in family incomes (after tax, national insurance and all benefits are deducted) for each decile of families in the Family Resources Survey, from poorest to richest.[158]

Some families gain by as much as 4 or 5 per cent in income. The shape of the distributional effects is similar for both versions of the reform. Note that this data is equivalised and includes the whole population, not just those in work. Those in the 1st and 2nd deciles are often in the full-time workforce so may not be able to take up so much of the benefit of a reform aimed at those in work. The biggest gainers (on average) are not the poorest, but people in the 6th and 7th deciles of the equivalised family income distribution. However, these families are far from wealthy. Table 14 shows the 'cut-off points' between each decile;[160] the deciles are much wider towards the top of the distribution than at the bottom.[161]

So for single people living individually, raising the tax threshold will mostly benefit earners of around £13–16,000 a year.

Still, even with these mitigating measures, this is not the cheapest way to cut poverty. Both measures cost in excess of £20 billion. Tax credits could do the job much more technically efficiently per pound spent. But this reform is not primarily about poverty. It is about fairness, clarity and justice. It is a message about how much the state should take and when, about the importance of and connection between hard work and fair reward. For progressive Conservatives, to take almost £1,000 in tax from someone on the minimum wage is simply wrong, and for the unity of our society, it is foolish too.

Conclusion: the first priority in recovery

As the economy returns to growth and tax revenues increase, cutting tax at the bottom, not the top, should be a priority of the coalition government. This is a policy both Conservatives and Liberal Democrats can unite around. Cutting Income Tax and national insurance contributions for the poorest in work is a quintessentially progressive Conservative policy: helping the poorest who work, not with hand-outs, but by getting the state off their back. It will build a culture of aspiration, hard work and self-reliance. Over time it is reasonable to predict it will bring benefits in a host of policy areas beyond taxation: cutting welfare dependency, boosting employment, strengthening family relationships, and tackling stress, depression and debt.

Ending waged social exclusion should be a flagship policy of the new coalition government. Returning the tax and national insurance threshold to nearer its historic levels is a very substantial step towards that objective. It is a moral outrage that government policy forces people towards the breadline to pay its taxes. We cannot expect to tackle the broken society if we continue to rely on broken tactics.

Raising the threshold is clear, effective and fair. We encourage all parties to pledge themselves to a cross-party consensus to make it a right that if you go out to work full time, as a single person without children, you will be able to earn the minimum needed to participate in society, and in time to reform the tax and tax credit system is to enable everyone, from all demographics, to lift themselves to the minimum income standard through their own hard work. It will not be done in a day, but making work pay is an essential first step to fixing our fractured society. In the 1970s the right railed against 98 per cent taxation on the richest.[162] Now it is time to apply the same urgency and moral force to fighting crippling taxes on the poorest who are trying to better themselves.

Annexes

Annex 1 How the minimum income standard compares with the average person's spend

One might argue that the minimum income standard is too generous. In addition to bare bones basics like food and shelter, the minimum income standard includes a budget for participating in social and cultural activities. The budget agreed by the participants in the minimum income standard research for a single person over 25 without children is given in table 15.

Table 15 **Items chosen as part of the minimum income standard social and portal participation budget for a single person over 25 without children**

Item	Quantity	Unit price (£)	Life (weeks)	Weekly cost (£)
Barbecue	1	24.99	104	0.24
Birthdays	1	150.00	52	2.88
CD player/radio	1	34.99	260	0.13
Christmas or equivalent festival	1	150.00	52	2.88
DVD	1	49.99	260	0.19
Football boots	1	25.00	104	0.24
Freeview box	1	29.99	260	0.12
General social activities	1	10.49	1	10.49
Self catering holiday cottage in UK for 1 week (1/2 total cost)	1	150.00	52	2.88
Shin pads (for football)	1	4.99	520	0.01
Stationery, newspaper, magazines, books	1	6.66	1	6.66
TV	1	89.99	260	0.35
TV licence	1	11.37	4.3	2.64
Total		738.46		29.71

Source: minimum income standard website.

This budget could be seen to include optional extras, not just real basics. Is it really necessary to provide everyone with a barbeque or a radio? Isn't the minimum income standard 'nice to have' not 'must have'?

The answer is emphatically no. First, it is vital to remember that this policy is not a transfer paid by taxpayers to those who do not contribute. No one is being 'provided' with anything. This is not a giveaway. The proposal made in this report is not to confiscate from one group in order to redistribute to another. To get the benefit of this reform, people must still go out to earn for themselves. In fact *this policy is the exact opposite of a hand-out. It is removing the penalty on effort to support oneself to the minimal standard of living*.

Second, the minimum income standard is still far below what might be considered a normal standard of living. The policy is not to allow everyone to earn tax free up to the average earnings but simply to a minimum standard. At present the minimum income standard is well below what the average 'man in the street' in Britain spends in almost every family type. For a single working aged adult, the total minimum income standard is £157.84 per week excluding housing costs, £105 less than actual mean expenditure across the population of that demographic as a whole. The total minimum income standard for a couple with two children per week excluding childcare and rent or mortgage is £370.05 per week. This is £240 less than actual average expenditure. The overall minimum income standard for a pensioner couple excluding housing costs is £201.49, £161 lower than mean national expenditure. The total minimum income standard for a lone parent with one child (toddler) excluding childcare is £210.31, which is £5 less than average actual expenditure. About three times as many pensioner couples in the population at large spend more than the minimum income standard budget than less. The same is true for couples with two children. On the other hand, among lone parents, who are far more likely to be on low incomes, about half spend above and half below the minimum income standard budgets.

Of course, for some budget items, the minimum income standard figure is near 100 per cent of the average spend, because those items are necessities for everyone. But comparing budget shares, the minimum income standard allows less than the average actual spending of people on income support and in social housing on water rates, council tax, fuel, other housing costs, household goods, alcohol and tobacco, and transport.[163]

Annex 2 Keeping the minimum income standard up to date

The minimum income standard will require recalculation over time. The cost of goods in the minimum income standard budgets will alter year by year and these changes will not exactly coincide with inflation in goods in the economy as a whole. Inflation is going to be higher for the items bought by poorer people. In spring 2010, although overall inflation is well below 1 per cent, the prices of food and heating (which form a large part of low-paid workers' budgets) are rising at an annual rate of more than 10 per cent. Housing costs are falling, and so are the costs of leisure and motoring, but these items make up a smaller proportion of what poorer workers spend their money on.[164] The significance of different rates of inflation for the poor and the rich has been underlined by the Institute for Fiscal Studies. Prices of the goods purchased by households in the poorest 10 per cent of the population rose by an average of 7.9 per cent in September 2009 compared with a rise of 5.1 per cent for the goods that households in the richest 10 per cent spent money on, and an average price rise in the expenditure of all households of 6.7 per cent.[165]

In 2009 the Joseph Rowntree Foundation commissioned an update to the 2008 minimum income standard figures.[166] Researchers found that the cost of goods in a minimum household budget rose by about 5 per cent that year for most family types. This is well above the general inflation rate, because someone on a minimum income spends a greater than average portion of their budget on food, domestic fuel and public transport, whose prices had risen by 7 to 12 per cent. The minimum budget also does not include a mortgage or running a car, whose falling costs have pulled down the general inflation rate.

In addition over time public perceptions of a minimum level of income necessary to participate in society will change too, and so the composition of the baskets themselves will require updating. We recommend that government should fund an annual update to the inflation rate in the minimum income standard goods, and a full renewal of the deliberative process to decide what constitutes the minimum income standard with the public every five years.

Annex 3 Methodology for calculating numbers below the minimum income standard

To analyse this issue we use the 2007–8 Family Resources Survey data to estimate the number of working age people whose net family income (the income of one or both adults in the family unit) is below the minimum income standard level.[167] We use before housing costs income rather than after housing costs income because housing cost information for the Family Resources Survey is collected at the household (rather than the family) level and we would have to restrict the analysis to households with only one family unit in them if we were to use after housing costs income for the analysis, resulting in a considerable reduction in sample size.

Analysis of the grossed-up[168] *Family Resources Survey shows that there were around 47 million adults in total in the UK in 2007/8. Of these, 35.9 million were under pensionable age.*[169] *Of these, 24.2 million were in work and earning enough to be taxed.*[170]

The Family Resources Survey was used to estimate the number of adults whose annual earnings from employment or self-employment were above £5,225 – the level of the Income Tax personal allowance for the tax year 2007/8 – but whose annual household earnings before housing costs were below the minimum income standard level. The tax system was then reformed by increasing the personal allowance to £9,806 per year and the employee national insurance contributions' primary threshold to the weekly equivalent of £9,806. This is an equivalent reform to that modelled elsewhere in this report for the current tax year. Household net incomes were adjusted to account for the reduced Income Tax and national insurance payments by men and women earning between £5,225 and £9,208 (gross) per year. The resulting increase in income moves some households who were previously below the minimum income standard level above it.

Annex 4 Impact of reform on the total population (in work and out of work)

Note: these figures take account of four demographics only, not the full range of demographics assessed by the original Joseph Rowntree Foundation research (couples with three children for example). They are therefore underestimates of the full numbers that would be affected by reform.

Table 16 **Number of adults in families with before housing cost income below the minimum income standard level, before and after proposed reform**

All adults	Total	Under minimum income standard: 2007/8 system		Under minimum income standard: reformed system		Fall in numbers as a result of reform (%)
Family type	Adults (m)	Adults (m)	% of total	Adults (m)	% of total	
Single, no children	10.6	4.45	42.00	4.04	38.10	9.21
Single with children	1.88	0.97	51.60	0.94	50.00	3.09
Couple, no children	12.47	1.95	15.60	1.81	14.50	7.18
Couple with children	10.96	2.39	21.80	2.15	19.60	10.04
Total	35.91	9.76	27.20	8.94	24.90	8.40

Table 17 **Number of children in families with before housing cost income below the minimum income standard level, before and after proposed reform**

All children	Total	Under minimum income standard: 2007/8 system		Under minimum income standard: reformed system		Fall in numbers as a result of reform (%)
Family type	Children (m)	Children (m)	% of total	Children (m)	% of total	
Single with children	3.04	1.68	55.30	1.63	53.60	2.98
Couple with children	9.75	2.69	27.60	2.33	23.90	13.38
Total	12.79	4.37	34.20	3.96	31.00	9.38

Table 18 **Number of families with before housing cost income below the minimum income standard level, before and after proposed reform**

All children	Total	Under minimum income standard: 2007/8 system		Under minimum income standard: reformed system		Fall in numbers as a result of reform (%)
Family type	Families (m)	Families (m)	% of total	Families (m)	% of total	
Single, no children	10.6	4.45	42.00	4.04	38.10	9.21
Single with children	1.88	0.97	51.60	0.94	50.00	3.09
Couple, no children	6.78	1.28	18.90	1.19	17.60	7.03
Couple with children	5.5	1.21	22.00	1.09	19.80	9.92
Total	24.76	7.91	31.90	7.26	29.30	8.22

Table 19 **Number of adults living in families with before housing cost income below 60 per cent median, before and after proposed reform**

All adults	Total	Under 60 per cent median: 2007/8 system		Under 60 per cent median: reformed system		Fall in numbers as a result of reform (%)
Family type	Adults (m)	Adults (m)	% of total	Adults (m)	% of total	
Single, no children	10.6	3.01	28.40	2.96	27.90	1.66
Single with children	1.88	0.46	24.50	0.44	23.40	4.35
Couple, no children	12.47	1.47	11.80	1.37	11.00	6.80
Couple with children	10.96	1.54	14.10	1.39	12.70	9.74
Total	35.91	6.48	18.00	6.16	17.20	4.94

Table 20 **Number of children in families with before housing cost income below 60 per cent median, before and after proposed reform**

All children	Total	Under 60 per cent median: 2007/8 system		Under 60 per cent median: reformed system		Fall in numbers as a result of reform (%)
Family type	Children (m)	Children (m)	% of total	Children (m)	% of total	
Single with children	3.04	0.83	27.30	0.81	26.60	2.41
Couple with children	9.75	1.62	16.60	1.49	15.30	8.02
Total	12.79	2.45	19.20	2.3	18.00	6.12

Table 21 **Number of families with before housing cost income below 60 per cent median, before and after proposed reform**

All families	Total	Under 60 per cent median: 2007/8 system		Under 60 per cent median: reformed system		Fall in numbers as a result of reform (%)
Family type	Families (m)	Families (m)	% of total	Families (m)	% of total	
Single, no children	10.6	3.01	28.40	2.96	27.90	1.66
Single with children	1.88	0.46	24.50	0.44	23.40	4.35
Couple, no children	6.78	0.98	14.50	0.92	13.60	6.12
Couple with children	5.5	0.78	14.20	0.71	12.90	8.97
Total	24.76	5.23	21.10	5.03	20.30	3.82

Table 22 **Number of adults in families in twilight zone before and after proposed reform**

All adults	Under minimum income standard: 2007/8 system		Under minimum income standard: reformed system		Fall in numbers as a result of reform (%)
Family type	Adults (m)	% of total	Adults (m)	% of total	
Single, no children	1.44	13.60	1.08	10.20	25.00
Single with children	0.51	27.10	0.5	26.60	1.96
Couple, no children	0.48	3.80	0.44	3.50	8.33
Couple with children	0.85	7.70	0.76	6.90	10.59
Total	3.28	9.20	2.78	7.70	15.24

Table 23 **Number of children in families in twilight zone before and after proposed reform**

All children	Under minimum income standard: 2007/8 system		Under minimum income standard: reformed system		Fall in numbers as a result of reform (%)
Family type	Children (m)	% of total	Children (m)	% of total	
Single with children	0.85	28.00	0.82	27.00	3.53
Couple with children	1.07	11.00	0.84	8.60	21.50
Total	1.92	15.00	1.66	13.00	13.54

Table 24 **Number of families in twilight zone before and after proposed reform**

Families	Under minimum income standard: 2007/8 system		Under minimum income standard: reformed system		Fall in numbers as a result of reform (%)
Family type	Families (m)	% of total	Families (m)	% of total	
Single, no children	1.44	13.60	1.08	10.20	25.00
Single with children	0.51	27.10	0.5	26.60	1.96
Couple, no children	0.3	4.40	0.27	4.00	10.00
Couple with children	0.43	7.80	0.38	6.90	11.63
Total	2.68	10.80	2.23	9.00	16.79

Source: Demos analysis of Family Resources Survey.

Notes

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5 This figure of 3.77 million includes children in working families.

6 Not in education, employment or training.

7 A person working full time. The assumption in this paper is that full time means 37.5 hours per week. The precise figure is £967; see www.libdems.org.uk/siteFiles/resources/PDF/Policy per cent20Briefing per cent20- per cent20Your per cent20Money per cent20Feb per cent2010.pdf (accessed Apr 2010).

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21 P Kenway, *Eradicating Child Poverty: The role of key policy areas; addressing in-work poverty* (York: Joseph Rowntree Foundation, 2008), www.jrf.org.uk/sites/files/jrf/2269-poverty-employment-income.pdf (accessed Apr 2010), 4. Note: these are pre-recession figures.

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23 The exact original quotation was in the aftermath of urban riots (Handsworth riots and the Brixton riot) in the summer of 1981. Tebbit responded to a suggestion by a Young Conservative (Iain Picton) that rioting was the natural reaction to unemployment by saying 'I grew up in the '30s with an unemployed father. He didn't riot. He got on his bike and looked for work, and he kept looking 'til he found it.' See http://en.wikipedia.org/wiki/Norman_Tebbit (accessed 21 May 2010).

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25 NI contributions are £110 per week free of contribution.

26 The two principal methodologies are the family budgeting approach, developed by the Family Budget Unit at the University of York, which was based on an expert understanding of need, and the Consensual Budget Standards approach of the Centre for Research in Social Policy at Loughborough University, which is based on involving members of the public in defining required levels of material resources.

27 The main research was based in various towns and cities in the Midlands. Participants were recruited and groups held in Northampton, Derby, Leicester and Loughborough.

28 The groups included white and ethnic minority participants, but budgets are not sensitive to ethnic diversity.

29 9.76 million adults and 4.37 million children. Before housing costs. Demos analysis of the Family Resources Survey. See annex 2 for further details.

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72 Kempson, *Life on a Low Income*.

73 Ridge, 'It's a family affair'.

74 Kempson, *Life on a Low Income*.

75 Ibid.

76 Sobolewski and Amato, 'Economic hardship in the family of origin and children's psychological well-being in adulthood'.

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100 J Hills, R Smithies and A McKnight, *Tracking Incomes: How working families' incomes vary through the year*, CASE report 132 (London: Centre for Analysis of Social Exclusion, Economic and Social Research Council and HM Revenue & Customs, 2006), http://sticerd.lse.ac.uk/dps/case/cr/ CASEreport32.pdf (accessed 21 May 2010); and Fair Pay Network, *Not Just for the Good Times*.

101 Not to be confused with the figure £10,200 given in the paragraph above; earnings of £10,400 is the threshold above which people would be above minimum income standard if they were not taxed, and continued to get the working tax credit. That is different from the point at which taxes and tax credits balance out under the present system (£10,200).

102 M Wind-Cowie, *Everyday Equality* (London: Demos, 2010).

103 F Bennett and R Lister, *The Living Wage: The right answer to low pay?* (London: Fabian Society, 2010), http://fabians.org/uk/publications/freethinking-papers/living-wage (accessed Apr 2010).

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105 See the campaigns of London Citizens; Bennett and Lister, *The Living Wage*; and Fair Pay Network, *Not Just for the Good Times*.

106 Wind-Cowie, *Everyday Equality*.

107 The next three graphs are based on analyses generated from Reform's tax calculators developed by Patrick Nolan, which can be found at www.reform.co.uk/Research/Economy/ReformTaxCalculators/tabid/167/Default.aspx; see also Nolan, *Reality Check*. Calculations do not include changes in other taxes (e.g. VAT and excises), only include standard personal allowances, and uprate incomes to 2009-10 assuming 3.5 per cent annual income growth. National insurance contributions include Class 1 contributions only.

108 Note: this paper is concerned with people of working age who are physically capable of work. We would argue for concomitant adjustments to benefits for those who cannot work through old age, sickness or disability, and those who can work and are behaving responsibly by actively looking for work, though none may be available through no fault of their own.

109 In fact, a 20 per cent 'flat tax' on earnings with a 20 per cent 'flat tax' on income with personal allowance left at the current level costs just over £25 billion. So such a policy would be slightly cheaper than raising the personal allowance to the minimum income standard. The full £26 billion of higher rate cuts would pay for a cut down to 19 per cent in higher rate of tax, which bizarrely would be lower than the current basic rate.

110 Many underpaid wage workers are migrants, who may look as though they are single and/or childless, but may have families abroad whom they are supporting financially out of their wages – and who, because of their immigration status, may have limited or no access to state benefits. More than two-thirds (64 per cent) of workers paid below the official poverty line are women. See 'Annual survey of hours and earnings 2006' in Bennett and Lister, *The Living Wage*, 11. Two in ten low-paid workers were aged between 18 and 21. Just 15 per cent of those working in their 30s and 40s were low paid; see G Cooke and K Lawton, *Working Out of Poverty: A study of the low-paid and the 'working poor'* (London: Institute for Public Policy Research, 2008).

111 There is little concrete evidence of the boost in productivity from universally higher wages. Most research focuses on the effect on one group if their wages are raised and the general population's held still. Nonetheless, Canadian research into raising take home wages across a whole region showed numerous benefits, including reduced stress; a greater sense of responsibility; a higher sense of self-worth; decline in worker absenteeism and improved health; reduced reliance on welfare programmes; increased savings, credit and investment in assets; enhanced workers' sense of inclusion, belonging and citizenship; reduced need to take a second low paying job to supplement an income; and increased time for family, recreation and participation in society. See 'A living wage policy impact assessment for the region of Waterloo: preliminary considerations', www.owr.ca/LivingWagePolicyImpact.pdf (accessed 21 May 2010) based on J Thompson and J Chapman, *The Economic Impact of Local Living Wages,* Briefing Paper 170 (London: Economic Policy Institute, 2008), www.epinet.org/briefingpapers/170/bp170.pdf (accessed Jan 2008).

112 A recent study by the Federal Reserve Bank of Chicago confirmed that low-paid American workers spent the whole of their minimum wage increases in the local economy, thus providing a very efficient economic stimulus; see D Aaronson, S Agarwal and E French, 'The spending and debt response to minimum wage hikes Chicago: Federal Bank of Chicago' in Fair Pay Network, *Not Just for the Good Times*.

113 Making the standard assumptions of working 37.5 hours a week, 52 weeks a year.

114 Defined as all single working aged adults over 25 without children in full-time employment over 30 hours a week.

115 This figure is only sufficient pay for a single person. It does not allow adults to support children or spouses to the minimum income standard.

116 This would not affect pension payments. Our proposal is that the lower earnings limit would be aligned with the Income Tax threshold.

117 The Income Tax personal allowance currently stands at £6,475 per year and the NI contributions primary threshold is £110 per week, equivalent to £5,720 a year. People who have earnings below these levels do not currently pay any Income Tax or employee NI contributions.

118 Excluding any dependants or children.

119 Defined as all single working aged adults over 25 without children in full-time employment over 30 hours a week.

120 Minimum wage times 37.5 for weekly wage, converted to annual.

121 'Your money', Liberal Democrat policy briefing, 2010, www.libdems.org.uk/siteFiles/resources/PDF/Policypercent20Briefingpercent20-percent20Yourpercent20Moneypercent20Febpercent2010.pdf (accessed 3 May 2010).

122 N Tebbit, 'Why won't the two main parties do anything about the madness of taxing the poor?', *Daily Telegraph*, 13 Jan 2010, http://blogs.telegraph.co.uk/news/normantebbit/100022127/why-wont-the-two-main-parties-do-anything-about-the-madness-of-taxing-the-poor/ (accessed Apr 2010).

123 The reform assumes no change in the tax credit system. Tax credits would continue to be paid on top of the new personal allowance.

124 Bamfield and Horton, *Understanding Attitudes to Tackling Economic Inequality*.

125 Ibid.

126 Ibid.

127 Ibid.

128 Ibid.

129 J Kirkup, 'Budget 2010: growth and borrowing figures "too optimistic"', *Daily Telegraph*, 24 Mar 2010 www.telegraph.co.uk/finance/financetopics/budget/7513757/Budget-2010-growth-and-borrowing-figures-too-optimistic.html (accessed 13 May 2010).

130 A household is one person, or a group of persons, who have the accommodation as their only or main residence and (for a group) share the living accommodation, that is a living or sitting room, or share meals together or have common housekeeping.

131 Gross household income includes 'original income' (such as wages, occupational pensions and investment income) plus cash benefits, both contributory and non-contributory (such as retirement pension, jobseeker's allowance and child benefit).

132 Income tax and council tax are counted as net payments – net of tax credits and any council tax benefit.

133 Jones, 'The effects of taxes and benefits on household incomes, 2006–07'.

134 £1 minus NI contributions at 11 per cent leaves 89 pence; 28.8 pence is 80 per cent of this 89 pence figure (tax being 20 per cent).

135 Kay, *Escaping the Poverty Trap*; Economic Dependency Working Group, *Dynamic Benefits*.

136 Justice Oliver Wendell Holmes. Reportedly said in a speech in 1904.

137 There are 30.8 million Income Taxpayers [HMRC statistics at www.hmrc.gov.uk/stats/income_tax/table2-1.pdf (accessed 12 May 2010)]. If basic rate of 20 per cent was levied on the first £6,475 of income for all of these people, the yield would be

£6,475 × 20 per cent × 30.8 million = £40 billion (approximately). There would also be those who are not currently taxpayers because they are earning less than the personal allowance but it is not possible to estimate how much tax it might generate.

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140 Smith, *An Enquiry into the Nature and Causes of the Wealth of Nations*; author's emphasis.

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146 Author's emphasis.

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153 The treatment of employee NI contributions is the same in both cases – the primary threshold and upper earnings limit rise in line with growth in the Income Tax personal allowance.

154 Based on the decile figures of Byrne and Ruane, *The UK Tax Burden*.

155 In practice a fractional percentage rate of Income Tax is unlikely. However a very similar effect could be achieved by raising the basic rate to 23 per cent, and increasing the personal allowance slightly so that taxpayers at the higher rate are again no better off.

156 A third option with much bigger savings would be to have say a 25 per cent band running to the break-even income level, then a 20 per cent band, but this would be complex and not consistent with the principle of simplicity.

157 April 2009 tax system.

158 Demos analysis based on the ippr tax and benefit model.

159 Note: The deciles are based on equivalised income in the Family Resources Survey – correcting for family size. The larger a family is, the lower its equivalised income is compared with its 'raw' income.

160 Net equivalised family incomes in the Family Resources Survey, for single and couple households (without children).

161 This measure of income is before housing costs because housing costs in the Family Resources Survey are only reliably available at household level, and some households contain multiple family units. The OECD equivalence scale is the scale that the UK government uses for its Households Below Average Income (HBAI) income statistics. The equivalence scale used is the OECD equivalence scale, which assumes that a single adult, no children household needs 67 per cent of the income of a two adult, no children household to maintain the same standard of living.

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168 The Family Resources Survey uses 'grossing factors' so that the 28,000 or so households in the survey can be analysed as a proxy for the *aggregate* effects of tax and benefit reforms (and other policy measures that affect incomes).

169 65 or over for men, or 60 or over for women.

170 Over the (then) personal allowance of £5,225.

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