



The Link Between Earnings & Living Standards: Impact of the Income Tax System

New Government figures show that taxpayers with children pay more tax than comparable taxpayers without children. Families are disadvantaged by the income tax system.

The latest Government figures show that in order to enjoy the same standard of living some families have to earn more than twice as much as someone without children and pay almost five times as much income tax.

Each year the Department of Work and Pensions (DWP) produce an analysis of household incomes. This show how families are faring – which are the better off households and which are the less well off. The figures for the tax year 2016/17 were released in March 2018¹. They tell us also about the number of households in poverty and how much income a household needs in order to be in the better off half of the population. In this paper we examine the 2016/17 figures and consider the tax policy implications.

The DWP figures are derived from the Family Resources Survey, a survey of more than 20,000 families. They provide by far the best information we have about the incomes of families. They need to inform tax policy. Successive Chancellors appear, however, to have largely ignored this data as many families who are less well off bear heavier income tax burdens than households who are better off. Families whose disposable income – the amount they have to live on – is so low that the Government regards them as being in poverty are nevertheless paying thousands of pounds in income tax.

Figures are published for income both before housing costs have been deducted (BHC) and after they have been deducted (AHC). In this paper we are using the AHC figures. There are a number of good reasons for this². AHC is a better indicator of living standards particularly as the BHC figures include housing benefits as income³.

The DWP figures, unlike income tax, are based on household income, which means than in the case of a couple family the incomes of both adults are taken into account. The resulting figures are rescaled ('equivalised') to take account of family size and composition and so reflect their different financial needs – a family of four needs a higher income than a single adult without dependents to have the same standard of living. The income measured is net income i.e. income after deducting income tax, employee and self-employed National Insurance Contributions, and council tax and includes state benefits and tax credits⁴. Commentators do not always make this clear, with the result that there is little understanding about how much a family needs to earn in order to be out of poverty or to be in the better-off half of the population. This leads to poor policy making.

The policy maker needs to know the household income and the composition of the households affected if the outcome is to be fair

An example of this failure is the High Income Child Benefit Charge (HICBC) which applies to one income families in circumstances where two income families, who may be much better-off, escape the charge altogether. Another example is provided by the increases in the tax threshold that have taken place since 2010. Most of the benefit has accrued to taxpayers who are in the better off half of the population.

As the IFS has pointed out, low pay does not necessarily equate with a low income or a low standard of living. Likewise high earnings do not necessarily mean that the earner is in the better off half of the population. The policy maker needs to know the household income and the composition of the households affected if the outcome is to be fair.

The DWP publish the income which various households need to be in the better off half of

¹ Households Below Average Income: An analysis of the UK income distribution: 1994/95-2016/17 IFS July 2017.

² Living Standards, poverty and inequality in the UK: 2017 Appendix A IFS July 2017.

³ A £10 rent increase can trigger a £10 increase in benefits even though there has been no change in the family's net income.

⁴ Households Below Average Income (HBAI) Quality and Methodology Information Report, page 24.

the population or to have an income which is less than 60% of the median. The latter is the figure under which the family is regarded as being in poverty.

The after housing cost figures for 2016/17 are below⁵:

| | AVERAGE INCOME | 60% MEDIAN |
|--------------------------------|----------------|------------|
| Couple No children | £425 | £255 |
| Single no children | £247 | £148 |
| Single one child under 14 | £332 | £199 |
| Single two children under 14 | £417 | £250 |
| Single three children under 14 | £502 | £301 |
| Couple one child under 14 | £510 | £306 |
| Couple two children under 14 | £595 | £357 |
| Couple three children under 14 | £680 | £408 |

In other words a single parent with a one child family is be regarded as being in poverty in 2016/17 if the amount it has to live on each week (its weekly disposable income) after housing costs were met was less than £199; and a couple family with two children aged under 14 is regarded as being in poverty if the amount they had to live on was less than £357 per week.

Tax policy discussion is focused around gross incomes. However, it is net income which matters when the distributional effects of tax changes are considered. It is net income that determines whether a household is in poverty.

In this paper we attempt to go behind these figures to see what typical families would have needed to earn in order to have an average income or an income high enough to take the family above the widely recognised poverty line of 60% median. It would be helpful if the Department of Work and Pensions could publish their estimates. It is important to know the gross income equivalents as most tax policy discussion is focussed around gross incomes rather than net incomes.

However it is net income which matters when the distributional effects of tax changes are considered. Also it is net income that determines whether a household is in poverty.

Gross income calculations are not straightforward as the DWP, quite sensibly, treats both tax credits and benefits as income. These are, however, means tested and vary with income. It is understood that childcare costs are not taken into account specifically although they are a major element in family budgets. Where tax credits apply the childcare element in the working tax credit would be included as income.

In all cases we assume that people work 30 hours a week, which may well be unrealistic in some cases.

Families with an average income

Table 1 below shows our estimates of the gross income which different households would have needed in 2016/17 in order to have an average income, i.e. to be in the better-off half of the population in that year after housing costs of £150 per week together with the income tax which they would have paid. The figures take account of child benefit and tax credit entitlement and where appropriate housing benefit.

⁵ Figures for couple no children and single no children taken from Table 4ts HBAI. Other figures calculated by Tax and the Family using the published DWP equivalisation factors.

Table 1
Gross income and tax paid in 2016/17 by households with an average income after housing costs of £150 per week

| HOUSEHOLD | GROSS INCOME | TAX | TAX AS % SINGLE NO CHILDREN | TAX AS % COUPLE NO CHILDREN | GROSS INCOME AS % SINGLE'S |
|--|--------------------|-------|-----------------------------------|-----------------------------------|-------------------------------|
| Single no children | 26958 | 3191 | 100% | 56% | na |
| Couple no children | 40671 | 5714 | 179% | 100% | 151% |
| Single + one child | 32016 | 4203 | 132% | 74% | 119% |
| Single + two children | 37647 | 5329 | 167% | 93% | 140% |
| Single + three children | 43174 | 6512 | 204% | 114% | 160% |
| Couple + one child one income | 46668 | 7909 | 248% | 138% | 173% |
| Couple +two children one income | 53603 | 10683 | 335% | 179% | 199% |
| Couple+ three children one income | 64396 ⁶ | 15000 | 470% | 263% | 239% |
| Couple +one child two equal incomes | 41975 | 3994 | 125% | 70% | 156% |
| Couple + two children two equal incomes | 47346 | 5068 | 159% | 89% | 176% |
| Couple +three children two equal incomes | 52821 | 6163 | 193% | 108% | 196% |

All these families are equally well off. However their gross incomes vary widely. The gross income required to give a family an average disposable income in 2016/17 varied from £43,174 in the case of a single income couple with three children to £26,958 in the case of a single adult with no children. A couple with one income and three children appears to need a pre-tax income of over £60,000 to be in the top half of the income distribution. With this income they not only pay higher rate tax, they are also liable to the High Income Child Benefit Charge unless they give up their child benefits.

The tax which households with an average income pay also varies significantly. The couple family with three children had income well over the higher rate threshold and paid over £15,000 income tax whereas the single adult with no children paid only £3,191. The couple with three children paid almost five times as much tax as a single person without children and two and a half times as much as a couple without children. All three households are regarded as having the same standard of living.

A single parent with two children has to earn 40% more than a single person without children and pay two thirds more tax in order to have the same living standard.

The difference between one-income families and two income families is also noteworthy. A single earner couple with children and an average income paid more than twice as much tax as a couple with two incomes, assuming a fairly equal split of the income. Single parent families however appear to be less disadvantaged because the formula which the DWP uses produces relatively low gross incomes for these families – their tax is comparable to that paid by two earner households.

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The figures in this and other Tables assume where appropriate that the marriage allowance is both due and claimed. Single earner households liable to higher rate tax cannot however claim this allowance. The figures for two income families have been calculated by

⁶ With an income above £60,000 the one earner family does not get child benefit. This explains the difference between a two child family and a three child family.

splitting the disposable income in half but allocating child benefit to one couple. In these illustrations we have assumed housing costs of £150 a week, or £650 a month. This is the figure in, for example, Leeds. But in some parts of the country housing costs are very much higher than that. In April 2016 the Local Housing allowance for a three bedroom house in North London was £354 per week and in Guildford £268 per week⁷. Table 2 below shows similar information as in Table 1 but for families with monthly housing costs of £1,500 or £346 per week.

Table 2

Gross income and tax paid in 2016/17 by households with an average income after housing costs of £346 per week

| HOUSEHOLD | GROSS INCOME | TAX | TAX AS % SINGLE | TAX AS % COUPLE | GROSS INCOME AS % SINGLE'S |
|--|--------------|-------|-----------------|-----------------|----------------------------|
| Single no children | 50735 | 9536 | 100% | 54% | N/A |
| Couple no children | 58244 | 12539 | 186% | 100% | 115% |
| Single + one child | 38846 | 5569 | 129% | 70% | 77% |
| Single + two children | 45834 | 7575 | 172% | 92% | 77% |
| Single + three children | 53029 | 10454 | 216% | 116% | 90% |
| Couple + one child one income | 67994 | 14124 | 280% | 127% | 134% |
| Couple +two children one income | 77224 | 16711 | 280% | 151% | 152% |
| Couple+ three children one income | 86296 | 18524 | 311% | 167% | 170% |
| Couple +one child two equal incomes | 56992 | 6998 | 105% | 56% | 112% |
| Couple + two children two equal incomes | 57514 | 8072 | 119% | 64% | 113% |
| Couple +three children two equal incomes | 62050 | 9167 | 134% | 73% | 122% |

With housing costs of £346 per week a single earner couple with three children may need to earn over £80,000 to have an average disposable income. Even a one child family would need an income of over £60,000, at which level they do not qualify for the marriage allowance and the HICBC will remove any advantage from receiving child benefit. Single people without children are unlikely to be paying a weekly rent of £346, but households with children in the more expensive parts of the country may have little alternative. As a result even a single parent with three children and an average standard of living may be paying over £10,000 in tax - more than twice that paid by a single person without children.

Families with an income below 60% median

Table 3 and 4 show estimates of the gross income required for families to have a disposable income equal to 60% of the median and thus out of poverty after housing costs on the Government's measure.

The calculations are however more difficult because many of the families will be entitled both to tax credits and housing benefits. These cash payments themselves vary with income and in the case of housing benefits with tax credits. Hence there is a large number of variables. Too much weight should not be placed on the individual figures, but the relationship between them and the broad pattern which emerges is clear.

⁷ Local Housing Allowance (LHA) rates applicable from April 2016 to March 2017 gov.uk

Table 3
Gross income required and tax paid with income equal to 60% median after housing of £150 per week in 2016/17

| HOUSEHOLD | GROSS INCOME | TAX | TAX AS % SINGLE NO CHILDREN | TAX AS % COUPLE NO CHILDREN | GROSS INCOME AS % SINGLE'S |
|--------------------------------------|--------------|------|-----------------------------------|-----------------------------------|-------------------------------|
| Single no children | 18146 | 1429 | 100% | 51% | N/A |
| Couple no children | 26071 | 2794 | 196% | 100% | 144% |
| Single + one child | 18928 | 1585 | 111% | 57% | 104% |
| Single + two children | 11263 | 52 | 4% | 2% | 62% |
| Single + three children ⁸ | 11263 | 52 | 4% | 2% | 62% |
| Couple + one child one income | 28470 | 3274 | 229% | 117% | 62% |
| Couple +two children one income | 31286 | 3837 | 269% | 179% | 172% |
| Couple+ three children one income | 34154 | 4411 | 309% | 158% | 188% |

The income which families need to earn in order to have an income equal to the 60% of the median varies from £11,263 in the case of a single parent with two or three children to £35,154 in the case of a single earner couple with three children. Tax credits provide better support for single parent families than it does for couples (Universal Credit provides more support for couple families). A single parent able to claim housing benefit for a rent of £150 per week appears has an income equal to 60% of the median when working 16 hours a week at the minimum wage.

It has not been possible to calculate the figures for two earner couples.

It will be noted that couple families in poverty may be paying significant amounts of income tax. Even a single parent with one child may be paying a four figure sum.

Table 4 sets out estimates for families with housing costs of £1500 per month or £346 a week – a more typical figure for London and the South East.

Table 4
Gross income required and tax paid with income equal to 60% median after housing costs and rent of £346 per week in 2016/17

| HOUSEHOLD | GROSS INCOME | TAX | TAX AS % SINGLE NO CHILDREN | TAX AS % COUPLE NO CHILDREN | GROSS INCOME AS % SINGLE'S |
|-----------------------------------|--------------|------|-----------------------------------|-----------------------------------|-------------------------------|
| Single no children | 33267 | 4453 | 100% | 97% | N/A |
| Couple no children | 35092 | 4598 | 103% | 100% | 105% |
| Single + one child | 35561 | 4912 | 110% | 107% | 107% |
| Single + two children | 38481 | 5496 | 123% | 120% | 116% |
| Single + three children | 41349 | 5496 | 123% | 120% | 116% |
| Couple + one child one income | 30399 | 3785 | 85% | 82% | 124% |
| Couple +two children one income | 30243 | 3629 | 81% | 179% | 91% |
| Couple+ three children one income | 32329 | 4046 | 91% | 88% | 97% |

⁸ The figures for single + two children and single + three children are the same because 16 hours at the minimum wage takes the family above the poverty line. A parent has to work 16 hours a week to get the Working Tax Credit.

With higher rents families may need to earn £35,000 to avoid being in poverty and their income tax liability could be over £5,000. In these examples single parent families appear to be worse off than single earner couple families. Unlike tax credits, housing benefit rules treat couple families more generously than single parent families. Even couple families living below the poverty line may be paying almost £4,000 a year in income tax.

Conclusions

The most obvious conclusion is that income tax liabilities are poorly related to how well off tax payers are – even taxpayers who live in households below the widely recognised poverty line pay significant amounts of income tax. Many will surely be shocked to learn how much income tax some families in poverty are paying. Even families in poverty with low incomes may have four figure income tax liabilities.

The failure of the income tax system to take any meaningful account of household income has resulted in the income tax burden being unfairly distributed. Better off households can be paying less tax than households who are much poorer. This has been the result of over focusing on individual income. Families have become dependent on means tested benefit income. This is a particular problem for the increasing number of families who are having to rent, rather than buy, their own homes. Families receiving housing benefit in addition to tax credits have a marginal tax rate of 96%. Even where housing benefit does not arise the marginal rate can be 73%. With marginal rates as high as this families have almost no control over their finances – they are totally dependent on the State. With a marginal rate of 96% it is impossible to repay a debt by working overtime or even finding a better paid job. They are completely locked in.

Universal Credit will help some families and will bring the top marginal rate down to 80%. Even at 80% families with debts or an unexpected large bill will face extreme difficulty. The problem is often seen as benefits problem and successive governments have tried to solve the problem by changes to benefits. It is very difficult to find or finance a benefit solution when income tax pays no regard to family size or composition. There are no easy solutions but policy makers surely do need to think about how income tax is structured. At the very least any future tax reductions should be focused on households with the

lowest incomes. This has not been the case for three decades or more. Are policy makers even aware of which households have above average income and which have below average income? The evidence suggests that many are not. At the very least there needs to be more informed debate about changes to both the income tax threshold and the higher rate threshold.

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