Office for Budget Responsibility

4 December 2015

Supplementary forecast information release: Tax credits costings – November 2015

The OBR is releasing the information below following a request for further detail underlying the November 2015 *Economic and fiscal outlook (EFO)*. The OBR will where possible meet requests to release supplementary forecast information, where this will improve the quality of public debate on the public finances. Our full release policy can be found on our website.

We have received a number of requests about the costing of the tax credit measures that the Government reversed in the Autumn Statement – specifically the difference between the savings that were estimated in the July 2015 Budget and the cost of reversing the measures in the Autumn Statement.

In all the tables in this note, a positive figure means a saving for the Exchequer (reducing public sector net borrowing (PSNB)) and a negative figure means a cost to the Exchequer (increasing PSNB).

The relevant measures were numbered 41 and 42 on the Treasury's scorecard of policy measures in the July Budget. The estimated saving from these two scorecard measures was £4.4 billion in 2016-17 falling to £3.7 billion in 2020-21. The OBR certified these costings at the time.

Table 2.1: Summer Budget 2015 policy decisions

		£ million				
		2016-17	2017-18	2018-19	2019-20	2020-21
Welfare						
41	Increase tax credits taper rate to 48%	+1,475	+1,035	+600	+345	+245
42	Reduce income thresholds in tax credits and work allowances in UC	+2,880	+3,060	+3,180	+3,310	+3,440
	Total for these two measures (OBR)	*+4,355*	*+4,095*	*+3,780*	*+3,655*	*+3,685*

The reversal of the measures was numbered 23 on the Treasury's scorecard in the Autumn Statement. The estimated cost of reversing the tax credit measures was £3.4 billion in 2016-17 falling to £0.5 billion in 2020-21. We also certified this costing in November.

Table 3.1: Autumn Statement 2015 policy decisions

		£ million				
		2016-17	2017-18	2018-19	2019-20	2020-21
Welfare						
23	Tax credits: maintain taper and income threshold	-3,385	-2,875	-1,735	-910	-465

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We have been asked about the difference between the £4.4 billion 2016-17 saving in July 2015 and the £3.4 billion 2016-17 cost of reversal in November 2015. In the rest of this note we set out the steps that account for that difference.

First, the costings presented in lines 41 and 42 of the Treasury's July 2015 scorecard include three separate changes:

- **Increase tax credits taper rate from 41% to 48%;**
- **Reduce income thresholds in tax credits**. This cut the working tax credits first income threshold from £6,420 to £3,850 and fed through to the child tax credits-only first threshold falling from £16,105 to £12,125; and
- **Reduce work allowances in UC**. This cut universal credit (UC) work allowances to £4,765 for those without housing costs, £2,305 for those with housing costs, and removed them altogether for non-disabled claimants without children.

Only the tax credits measures were reversed in November, so the first source of difference between the July 2015 savings and the November 2015 cost reflects the saving from the reduction in UC work allowances. That element of the July cuts was estimated to save £0.1 billion in 2016-17 rising to £3.2 billion in 2020-21 (Table 1).

Table 1: July 2015 scorecard costing for the cut in work allowances in UC

	£ billion				
	2016-17	2017-18	2018-19	2019-20	2020-21
Universal credit marginal impact	0.1	1.2	2.2	2.8	3.1
- UC transitional protection costs associated with above	0.0	0.0	0.0	0.0	0.0
- Northern Ireland consequential	0.0	0.0	0.1	0.1	0.1
Total as presented on the July scorecard	**0.1**	**1.2**	**2.2**	**2.9**	**3.2**

Looking only at the tax credits measures, on a like-for-like basis the July 2015 saving would have been £4.2 billion in 2016-17, falling steadily to £0.5 billion in 2020-21 as the number of families claiming tax credits falls in line with the natural and managed migration of claims to UC (Table 2).

Table 2: July 2015 scorecard costing for the reversed tax credits measures

	£ billion				
	2016-17	2017-18	2018-19	2019-20	2020-21
Tax credits entitlement impact	4.7	4.7	4.6	4.6	4.7
- impact on UC marginal cost	-0.2	-1.6	-3.0	-3.8	-4.2
- impact on net overpayments	0.1	0.0	0.0	0.0	0.0
- impact on existing debt recovery and other measures	-0.1	-0.1	0.0	0.0	0.0
- impact on housing benefit	-0.2	-0.1	-0.1	0.0	0.0
Total for the reversed tax credits measures	**4.2**	**2.9**	**1.5**	**0.8**	**0.5**

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After all Budgets and Autumn Statements, the estimates of policy costings are reviewed in light of the latest information as they are incorporated into our 'baseline' pre-measures forecast for the next fiscal event. As we prepared our November 2015 forecast, this process revealed a number of issues that had not been factored in correctly into July costing. This included:

- **higher consequential spending on housing benefit** (£0.45 billion in 2016-17). The impact of changes in income from tax credits on spending on housing benefit (since the latter is means-tested on net income) was estimated using a ready-reckoner that has now been shown to have underestimated that effect.[1] Having further examined the particular groups affected by the tax credit measures – individuals that are more likely to be working – the estimate of the proportional impact was revised up from 4 to 5 per cent to 15 per cent;

- **lower savings from the impact on tax credits error and fraud** (£0.15 billion in 2016-17). Assuming a constant proportion of spending associated with error and fraud, reducing spending on tax credits reduces the underlying level of error and fraud. This in turn means there is less error and fraud to be tackled by previous policy measures that target such savings. This knock-on effect of the main costing had not been estimated in July 2015; and

- **other small changes** including incorporating the impact on spending in Northern Ireland and higher spending on tax-free childcare.

A number of these issues were reported in Box 4.3 of our November *EFO*, where we also noted that the policy costings process itself had contributed to the estimates of interactions not capturing all aspects fully. In particular, these estimates were not scrutinised until just before our deadlines, which contributed to some effects being underestimated and some effects not being identified as interactions that needed to be estimated. As we noted in Box 4.3 *"this reflects the challenge of estimating interactions between HMRC tax credits and DWP benefits in the run-up to a fiscal event, where the Treasury's policy costings process does not permit us to call on the expertise of officials across both departments on all measures that might be subject to interactions."*

Recosting the July 2015 tax credits measures with these revised estimates of interactions included would mean that the tax credit measures would only have shown a saving of £3.6 billion in 2016-17 in July (Table 3).

[1] This allows housing benefit consequentials of policy measures to be estimated without running the full effects through detailed policy simulation or forecast models, which was necessary given the time constraints of the policy costing process.

Table 3: July 2015 reversed tax credit measures with interactions recosted

	£ billion				
	2016-17	2017-18	2018-19	2019-20	2020-21
Tax credits entitlement impact	4.7	4.6	4.6	4.5	4.6
- impact on UC marginal cost	-0.2	-1.6	-3.0	-3.7	-4.1
- impact on net overpayments	0.1	0.1	0.0	0.0	0.0
- impact on existing debt recovery and other measures	-0.3	-0.2	-0.1	-0.1	-0.1
- impact on housing benefit	-0.7	-0.5	-0.2	-0.1	-0.1
- impact on tax-free childcare	0.0	0.0	0.0	0.0	0.0
- impact on other off-model adjustments	0.0	0.0	-0.1	-0.1	-0.2
- Northern Ireland consequential	0.0	-0.1	-0.1	-0.1	-0.1
Total for the reversed tax credits measures	**3.6**	**2.3**	**1.0**	**0.3**	**-0.1**
Change on July 2015	**-0.6**	**-0.6**	**-0.5**	**-0.5**	**-0.5**

Our forecasts of spending on tax credits and UC have been revised for other reasons since July – for example, lower 2015-16 outturns for tax credit spending and the latest UC rollout delay. This means that if the tax credit measures were costed against our latest pre-measures forecast, they would have saved slightly less again in the near term (reflecting the lower outturns being fed into the forecast), but slightly more at the end of the forecast period (due to the UC rollout delay) (Table 4).

Table 4: Recosted July tax credits measures against a November forecast baseline

	£ billion				
	2016-17	2017-18	2018-19	2019-20	2020-21
Tax credits entitlement impact	4.6	4.6	4.5	4.5	4.5
- impact on UC marginal cost	-0.2	-0.9	-2.1	-3.1	-3.8
- impact on net overpayments	0.1	0.1	0.0	0.0	0.0
- impact on existing debt recovery and other measures	-0.3	-0.1	-0.1	-0.1	0.0
- impact on housing benefit	-0.7	-0.6	-0.4	-0.2	-0.1
- impact on tax-free childcare	0.0	-0.1	0.0	0.0	0.0
- impact on other off-model adjustments	-0.2	-0.1	-0.1	-0.1	-0.1
- impact on transitional protection costs in UC	0.0	0.0	0.0	0.1	0.2
- Northern Ireland consequential	0.0	0.0	-0.1	-0.1	-0.1
Total for the reversed tax credits measures	**3.4**	**2.9**	**1.7**	**0.9**	**0.5**
Change on July 2015 with interactions recosted	**-0.2**	**0.6**	**0.7**	**0.6**	**0.5**

After the three steps of removing the effect of the UC work allowance change, correcting various interactions and updating the baseline forecast, the revised savings from the July tax credit measures would have been £3.4 billion in 2016-17 falling to £0.5 billion in 2020-21. These changes are reflected in the pre-measures forecast of welfare spending in Table 4.22 of our November 2015 *EFO*.

The November 2015 policy costing of reversing these two tax credits measures (Table 5) is simply the reversal of the amount the two measures would have been expected to save relative to the November forecast baseline and with the interactions costed in a way that we now consider central.

Table 5: November 2015 scorecard costing of reversing the two July tax credits measures

	£ billion				
	2016-17	2017-18	2018-19	2019-20	2020-21
Tax credits entitlement impact	-4.6	-4.6	-4.5	-4.5	-4.5
- impact on UC marginal cost	0.2	0.9	2.1	3.1	3.8
- impact on net overpayments	-0.1	-0.1	0.0	0.0	0.0
- impact on existing debt recovery and other measures	0.3	0.1	0.1	0.1	0.0
- impact on housing benefit	0.7	0.6	0.4	0.2	0.1
- impact on tax-free childcare	0.0	0.1	0.0	0.0	0.0
- impact on other off-model adjustments	0.2	0.1	0.1	0.1	0.1
- impact on transitional protection costs in UC	0.0	0.0	0.0	-0.1	-0.2
- Northern Ireland consequential	0.0	0.0	0.1	0.1	0.1
Total for the reversed tax credits measures	**-3.4**	**-2.9**	**-1.7**	**-0.9**	**-0.5**
Change on July 2015 scorecard costing	**-1.0**	**-1.2**	**-2.0**	**-2.7**	**-3.2**
Change on like-for-like July 2015 scorecard costing	**-0.9**	**0.0**	**0.2**	**0.1**	**0.0**